

**NAVIGATING UNCHARTED WATERS:  
THE NEW CHARITABLE LEGISLATION**

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I. IMPROVED ACCOUNTABILITY OF DONOR-ADVISED FUNDS.

A. Study on Donor-Advised Funds and Supporting Organizations.

1. Instead of enacting many of the provisions affecting donor-advised funds and supporting organizations that were included in Senate Bill 2020 (many of which were controversial), the Act directs a study on the organization and operation of donor-advised funds and supporting organizations to be presented to the Senate Finance Committee and the House Ways and Means Committee by August 17, 2007. The study is to consider the following:
  - a. Whether charitable deductions for contributions to these organizations are appropriate in light of the use of contributed assets (including the type, extent, and timing of such use), the use of the assets of such organization for the benefit of the person making the charitable contribution (or related persons);
  - b. Whether donor-advised funds should be required to distribute a certain amount;
  - c. Whether the retention of certain rights (including advisory rights or privileges) over contributions to donor-advised funds or supporting organizations is consistent with the treatment of such transfers as completed gifts; and
  - d. Whether there are other types of charities or charitable donations that raise similar issues.
2. IRS Notice 2007-21 requested public comments on the issues that should be included in this study. Comments are required to be submitted by April 9, 2007.

B. Definition of Donor-Advised Fund. The Act provides definitions of “donor-advised fund” and “sponsoring organization” for purposes of these new rules.

1. A donor-advised fund is a fund or account (1) which is separately identified by reference to contributions of a donor or donors, (2) which is owned and controlled by a sponsoring organization, and (3) with respect to which a donor (or any person appointed or designated by the donor (called a “donor advisor”)) has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of the assets of the separately identified fund or account by reason of the donor’s status as donor.

- a. To be a donor-advised fund, the fund or account must meet all three of the requirements listed above.
  - b. To be a donor-advised fund, the fund or account must reference the contribution of a specific donor or donors. A general fund or account or one that receives contributions from multiple donors whose contributions are not separately accounted for within the fund will not be a donor-advised fund.
  - c. The Internal Revenue Service will look to the actual manner of operations of the fund in determining if it is separately identified by reference to contributions of a donor or donors.
  - d. Advisory privileges do not include enforceable rights or obligations under a gift agreement.
  - e. Advisory privileges may be set forth in a written agreement, but, even in the absence of written agreement, may be inferred from the conduct of the donor and the sponsoring organization. But, the donor does not have advisory privileges if the donor provides advice without some sort of reciprocity on the part of the sponsoring organization.
  - f. It is not necessary that the donor actually provide advice, if the donor reasonably expects to have advisory privileges with respect to the fund or account and that expectation is reciprocated by some action on the part of the sponsoring organization.
  - g. Advisory privileges do not include privileges based upon the donor's position as an officer, employee, or director of the sponsoring organization in the absence of other factors, unless such position resulted from the establishment of the fund.
2. A donor-advised fund does not include any fund or account that (a) makes distributions only to a single identified organization or governmental entity, (b) with respect to which the donor recommends to the sponsoring organization the selection of the committee members that will provide investment and distribution advice if the recommendations are based on objective criteria related to the expertise of the member, or (c) with respect to which a donor or person appointed or designated by the donor advises as to which individuals receive grants for travel, study, or other

similar purposes if (i) the advisory committee for such fund is composed only of members that are appointed by the sponsoring organization and is not controlled by the donor or persons appointed or designated by the donor and (ii) grants are awarded on an objective and nondiscriminatory basis in accordance with procedures meeting the requirements for similar grants by private foundations and these procedures have been approved in advance by the board of the sponsoring organization.

3. The Internal Revenue Service also is granted the authority to exempt other funds or accounts from the definition (a) if the fund or account is advised by a committee not directly or indirectly controlled by the donor or any person appointed or designated by the donor or (b) if such fund benefits a single identified charitable purpose.
4. A sponsoring organization is any organization that is described in section 170(c) (other than section 170(c)(1) and without regard to section 170(c)(2)(A)), is not a private foundation, and maintains one or more donor-advised funds.

C. Tax on Taxable Distributions.

1. The Act imposes a 20 percent excise tax on a sponsoring organization that makes a taxable distribution. The tax is imposed on the amount of the taxable distribution.
2. There is also a five percent excise tax imposed on any fund manager of the sponsoring organization who agreed to the making of the distribution (but the maximum tax in the aggregate that can be imposed on fund managers is \$10,000).
3. A fund manager is defined as an officer, director, or trustee of the sponsoring organization or an individual having similar powers or responsibilities and, with respect to any act or failure to act, the employees of the sponsoring organization having authority or responsibility with respect to such act (or failure to act).
4. A taxable distribution is any distribution from a donor-advised fund to (a) an individual or (b) any other person if the distribution is for other than an exempt purpose under section 170(c)(2)(B) or, if for a charitable purpose, the sponsoring organization does not exercise expenditure responsibility with respect to such distribution.
5. A taxable distribution does not include a distribution to any organization described in section 170(c)(2)(B) (other than a grant to a Type III supporting organization that is not a functionally

integrated Type III supporting organization or to a Type I or Type II supporting organization if the donor or anyone appointed or designated by the donor for the purpose of advising the donor-advised fund directly or indirectly controls a supported organization). It also does not include any grant to the sponsoring organization or any other donor-advised fund.

6. These provisions are effective for taxable years beginning after August 17, 2006.
- D. Taxes on Prohibited Benefits. The Act enacts a new section 4967 that imposes significant excise taxes on certain transactions that result in prohibited benefits.
1. That section imposes a 125 percent excise tax if any donor, donor advisor, or related person provides advice to a sponsoring organization causing a distribution from a donor-advised fund that results in that person or any other donor, donor advisor, or related person receiving, directly or indirectly, a more than “incidental benefit.” The tax is paid by any such person who advises as to the distribution or who receives a benefit as a result of the distribution.
  2. Any fund manager who agrees to the making of the distribution, knowing that it would confer a prohibited benefit, is also subject to a 10 percent excise tax (with a cap on the total tax for fund managers of \$10,000).
  3. A more than incidental benefit is any benefit that would have resulted in a reduction of the income tax charitable deduction had the person made a direct contribution to the charitable recipient.
  4. These taxes do not apply if the transaction results in a tax under the excess benefit transaction rules of section 4958.
  5. These provisions are effective for all taxable years beginning after August 17, 2006.
- E. Application of Excess Benefit Transaction Rules to Donor-Advised Funds and Sponsoring Organizations.
1. The Act modifies the excess benefit transaction provisions of section 4958 to treat donors, donor advisors, and investment advisors to donor-advised funds and family members of such persons or entities 35 percent controlled by them or family members as disqualified persons with respect to the sponsoring organization under the excess benefit transaction rules of section 4958. An investment advisor is any person compensated by the sponsoring organization for managing the investment of, or

providing investment advice with respect to, assets maintained in donor-advised funds owned by the sponsoring organization.

2. The new rules treat any grant, loan, compensation, or other similar payment, such as an expense reimbursement, distributed to a donor, donor adviser, or person related to a donor or donor adviser as an *automatic* excess benefit transaction. The entire amount distributed to such person is treated as an excess benefit for purposes of section 4958. Any correction amount cannot be held in or credited to the donor-advised fund.
3. These rules apply to transactions occurring after August 17, 2006.

F. Application of Excess Business Holdings Rules to Donor-Advised Funds. The Act applies the private foundation excess business holdings rules of section 4943 to donor-advised funds.

1. The private foundation excess business holdings rules provide that the amount of holdings of the organization in a business enterprise, when combined with the holdings of disqualified persons, cannot exceed 20 percent. Any holdings in excess of this amount are subject to an excise tax. A disqualified person includes any person who is a disqualified person for purposes of the new rules imposing an excise tax on prohibited distributions from a donor-advised fund, as well as family members of such individuals and 35-percent controlled entities.
2. The provision also adopts certain transitional rules that had applied to private foundations after the enactment of section 4943 in 1969 to allow a period of time to dispose of these excess business holdings. While these transitional rules are extraordinarily complex, it appears that existing holdings of a donor-advised fund holding 95 percent or more of the voting stock in the business enterprise may be held for up to 20 years without imposition of an excise tax.
3. These rules would apply to taxable years beginning after August 17, 2006.

G. Charitable Contributions to Donor-Advised Funds.

1. An income, estate, or gift tax charitable deduction is denied for any contribution to a donor-advised fund if the sponsoring organization is a Type III supporting organization (other than a functionally integrated Type III supporting organization) or a Type I or Type II supporting organization if the donor or an advisor controls a supported organization.

2. No income, gift, or estate tax deduction is available for a contribution to a donor advised fund maintained by a veterans' organization or fraternal society and no income tax deduction is available for such a gift to a cemetery company.
3. Further, no deduction is allowed for a contribution to a donor-advised fund unless the donor obtains a contemporaneous written acknowledgement from the sponsoring organization that states that the sponsoring organization has exclusive legal control over the assets contributed. These rules apply to contributions made after the date that is 180 days after August 17, 2006.

H. Annual Returns and Exemption Applications for Sponsoring Organizations.

1. The Act requires disclosure on the exemption application of an organization that intends to maintain donor-advised funds and detailed information regarding the manner of operating these funds.
2. A sponsoring organization is also required to include certain information on its Form 990 including the total number of donor-advised funds owned by it at the end of the taxable year, the aggregate value of assets held in such funds at the end of the taxable year, and the aggregate contributions to and grants made from such funds during the taxable year.
3. The rules apply to returns or exemption applications filed after August 17, 2006.

II. IMPROVED ACCOUNTABILITY OF SUPPORTING ORGANIZATIONS.

A. Additional Requirements for Classification as Type III Supporting Organization. The Act adds a new subsection (f) to section 509, effective as of August 17, 2006, imposing additional requirements that must be met to qualify as a Type III supporting organization. These additional requirements are as follows:

1. In each tax year beginning after August 17, 2006, the supporting organization must provide each supported organization with such information as the Secretary of the Treasury may require to ensure that the supporting organization is responsive to the needs or demands of the supported organization. This information is intended to include a copy of the supporting organization governing documents and any amendments thereto, the Form 990, the Form 990-T, if any, and an annual report. The proposed regulations issued on August 2, 2007 and discussed in more detail below provide new guidance as to the form, content, and timing of

the required information that must be provided to each supported organization.

2. The supporting organization cannot support an organization that is not organized in the United States. (This rule does not apply until the first day of the organization's third tax year beginning after August 17, 2006 for existing organizations operated in connection with a foreign organization.)
3. Type I and Type III supporting organizations cannot receive contributions from certain persons. These persons include (a) a person who directly or indirectly controls (either alone or with other persons described in (b) or (c) following) the governing body of the supported organization, (b) a family member of a person described in (a), and (c) a 35-percent controlled entity.

B. Minimum Distribution Requirements.

1. Unlike Senate Bill 2020, which would have imposed an excise tax on a Type III supporting organization that does not make a certain level of distributions to or for the use of its supported organization(s), the Act instead requires the Internal Revenue Service to issue new regulations under section 509 on payments required by Type III supporting organizations that are not functionally integrated Type III supporting organizations. These regulations must require such organizations to make distributions of either a percentage of either income or assets to supported organizations in order to ensure that a "significant amount" is paid to such organizations.
2. A functionally integrated Type III supporting organization is defined as a Type III supporting organization that is not required under regulations to be issued by the Internal Revenue Service to make payments to supported organizations because the activities of the organization are related to performing the functions or, or carrying out the purposes of, such supported organizations.
3. There is no provision for taxing an organization for failure to make such distributions. Instead, the implication is that the organization would no longer qualify as a supporting organization if it failed to comply with the regulations and would likely be reclassified as a private foundation.
4. Effective February 22, 2007, an Internal Revenue Service memorandum drafted by the director of exempt organizations rulings and agreements announced a suspension of the issuance of determination letters to organizations seeking to be classified as

functionally integrated Type III supporting organizations pending the issuance of guidance on this issue. On September 28, 2007, the Internal Revenue Service lifted this ban because the Internal Revenue Service has specific guidelines in place for making the required determinations. An Internal Revenue Service memorandum dated September 24, 2007 sets forth guidelines to EO Determinations for handling requests from organizations for classification under Internal Revenue Code section 509(a)(3) and in particular the manner of handling a request from an organization seeking classification as a functionally integrated Type III supporting organization. Accompanying this memorandum was a guide sheet to assist in determining public charity status under Internal Revenue Code section 509(a)(3). The guide sheet specifically notes that it asks for more information than is currently requested by Schedule D of Form 1023 because of changes made by the Act and the need for heightened scrutiny because some supporting organizations are being used to inappropriately benefit private interests.

5. On August 2, 2007, the Internal Revenue Service issued a notice of proposed rulemaking regarding proposed regulations imposing a new minimum payout on Type III supporting organizations and addressing other provisions of the Act applicable to supporting organizations. The Internal Revenue Service is requesting comments on the proposed regulations by October 31, 2007.
  - a. The proposed regulations define the term “functionally integrated,” which is key to determining whether a number of provisions of the Act apply to a Type III supporting organization. A functionally integrated Type III organization is one that is not required to make payments to supported organizations because the activities of the organization are related to performing the functions, or carrying out the purposes of, such supported organizations. These proposed criteria will replace the integral part test in the current regulations. The functionally integrated definition will encompass organizations that meet the “but for” test in existing Regulation § 1.509(a)-4(i)(3)(ii) and an expenditure test and an assets test similar to those that apply for determining if an organization is a private operating foundation under Internal Revenue Code section 4942(j).
  - b. The proposed regulations impose a new minimum payout requirement on Type III supporting organizations that are not functionally integrated. In addition, these organizations may only support a limited number of organizations. The

payout requirement will require an annual distribution of at least five percent of the aggregate fair market value of all of an organization's assets. The number of publicly supported organizations that a non-functionally integrated Type III supporting organization may support will be limited to no more than five. An exception is made for organizations already in existence, which may support more than five organizations, but only if the supporting organization distributes at least 85 percent of its total required payout to organizations to which it is responsive.

6. In a follow up to the earlier August 2, 2007 advance notice of proposed rulemaking, in Announcement 2007-87, which was published on October 1, 2007, the Internal Revenue Service said that it plans to propose regulations that would require Type III supporting organizations that are not functionally integrated to meet a payout requirement equal to the minimum distribution rules that apply to nonoperating private foundations under Internal Revenue Code section 4942.

C. Charitable Trusts.

1. The Act also eliminates a special rule that currently allows certain charitable trusts to qualify as Type III supporting organizations. Under this provision, a charitable trust will no longer be a Type III supporting organization solely because it is a charitable trust under state law, the supported organization is a beneficiary of the trust, and the supported organization has the power to enforce the trust and compel an accounting. These changes are generally effective as of August 17, 2006, but are effective on the date that is one year after August 17, 2006 for trusts that are already in existence.
2. In accordance with the provisions of the Act applicable to charitable trusts classified as supporting organizations, the proposed regulations issued on August 2, 2007 no longer allow a charitable trust to qualify as a Type III supporting organization if it only satisfies the responsiveness test because it is a charitable trust under state law, the supported organization is a beneficiary of the trust, and the supported organization has the power to enforce the trust and compel an accounting under applicable state law. These charitable trusts must now satisfy the responsiveness test under Regulation § 1.509(a)-4(i)(2)(ii). Thus, a trust must show that the trustees have a close, continuous working relationship with the officers, directors, or trustees of the supported organization, and that this relationship results in the officers, directors, or trustees of the supported organizations having a significant voice in the operations of the trust.

3. In Notice 2008-6 released on January 22, 2008, the Internal Revenue Service announced transitional relief for charitable trusts affected by this change. Under this relief, charitable trusts that became private foundations as of August 17, 2007 should continue to file Form 990 for tax years beginning before 2008 and will not be required to pay any excise taxes on net investment income until its first tax year beginning after 2007. For tax years beginning on or after January 1, 2008, these charitable trusts will be required to file Form 990-PF.
- D. Application of Excess Benefit Transaction Rules to Supporting Organizations. These provisions apply to all types of supporting organizations and provide that an excess benefit transaction *automatically* includes (a) any grant, loan, compensation, or other payment, such as an expense reimbursement, made by a supporting organization to a substantial contributor or his family members and entities 35 percent controlled by such persons and (b) any loan provided by a supporting organization to a disqualified person (which would include a director of the organization). These rules apply to transactions occurring after July 25, 2006. Also, a person who is a disqualified person with respect to a supporting organization will also be a disqualified person with respect to the supported organization. This provision applies to transactions occurring after August 17, 2006.
- E. Application of Private Foundation Excess Business Holdings Rules to Qualified Supporting Organizations. The Act applies the private foundation excess business holdings rules of section 4943 to certain supporting organizations. The supporting organizations subject to these rules include Type III supporting organizations (other than a functionally integrated Type III supporting organization) and a Type I or Type II supporting organization if the supported organization is controlled by the supporting organization's donors. A functionally integrated Type III supporting organization is defined as a Type III supporting organization that is not required (under regulations to be issued by the Internal Revenue Service) to make payments to supported organizations because the activities of the organization are related to performing the functions or, or carrying out the purposes of, such supported organizations.
1. The private foundation excess business holdings rules provide that the amount of holdings of the organization in a business enterprise, when combined with the holdings of disqualified persons, cannot exceed 20 percent. Any holdings in excess of this amount are subject to an excise tax. These rules apply the broader definition of disqualified person, however, that is found under the excess benefit transaction rules of section 4958.

2. The Act offers some relief from the application of these rules. The Secretary of the Treasury may exempt any qualified supporting organization from the application of these rules if the Secretary determines that the excess business holdings of such organization are consistent with the purpose or function constituting the basis for its exemption under section 501. In addition, in the case of a Type III supporting organization (such as the Hershey Trust), excess business holdings do not include any holdings in any business enterprise if, as of November 18, 2005, the holdings were held (and at all times thereafter are held) for the benefit of the community pursuant to the direction of a State attorney general or a State official with jurisdiction over the Type III supporting organization.
  3. The provisions also adopt certain transitional rules that had applied to private foundations after the enactment of section 4943 in 1969 to allow a period of time to dispose of these excess business holdings. While these transitional rules are extraordinarily complex, it appears that existing holdings of a supporting organization holding 95 percent or more of the voting stock in the business enterprise may be held for up to 20 years without imposition of an excise tax.
  4. These rules apply to taxable years beginning after the date of enactment.
- F. Distributions from Nonoperating Private Foundations to Supporting Organizations.
1. The Act excludes from the definition of a “qualifying distribution,” for purposes of the minimum distribution rules applicable to private foundations, any amount paid by a private foundation that is not an operating foundation to a Type III supporting organization that is not a functionally integrated Type III supporting organization or to a Type I or Type II supporting organization if a disqualified person with respect to the private foundation directly or indirectly controls the supporting organization or a supported organization of the supporting organization. The Internal Revenue Service may determine, by regulation, that other distributions to supporting organizations should be excluded from the definition of qualifying distributions as well.
  2. Conforming changes are made to the taxable expenditure rules applicable to private foundations under section 4945. Under these changes, a private foundation that makes distributions to a Type III

supporting organization that is not functionally integrated must exercise expenditure responsibility over the grant.

3. These amendments apply to distributions and expenditures made after August 17, 2006.
4. IRS Notice 2006-109 provides interim guidance, pending the issuance of regulations, on how to determine the tax classification of a public charity for purposes of these rules.

G. Additional Filing Requirements Imposed on Supporting Organizations.

1. All supporting organizations will be required to file an annual return and cannot be accepted from the filing requirement by discretion of the Secretary of the Treasury.
2. Certain information must be included on the annual return of a supporting organization, including (a) a list of the supported organizations, (b) an indication of whether the supporting organization is a Type I, Type II, or Type III supporting organization, and (c) a certification that the supporting organization meets the limitations imposed under section 509(a)(3) regarding control by disqualified persons.
3. A supporting organization should be able to provide certification that a majority of its governing body is comprised of persons selected because of their expertise or knowledge in a relevant field or because they are representative of the community being served.
4. These provisions apply to returns filed for taxable years ending after the date of enactment. Thus, a calendar year organization is required to adhere to these rules when filing its 2006 Form 990.

- H. Reclassification. IRS Announcement 2006-93 sets forth the procedure to be followed by an organization seeking a reclassification of status from a supporting organization to a publicly supported organization.

III. CHARITABLE GIVING INCENTIVES.

- A. IRA Charitable Rollover. The Act provides an exclusion from gross income for certain otherwise taxable IRA distributions from a traditional or Roth IRA in the case of qualified charitable distributions. Qualified charitable distributions are any distributions up to \$100,000 per year from an IRA made during 2006 and 2007 directly by the IRA trustee to a qualified charitable organization if the IRA owner has attained age 70½. The exclusion is not available for a distribution to fund a charitable remainder trust, pooled income fund, or charitable gift annuity. A qualified charitable organization is one described in section

170(b)(1)(A) (i.e., a public charity) other than a supporting organization or a donor-advised fund. Contributions to private foundations do not qualify for the exclusion. The IRA owner is not entitled to an income tax charitable deduction under section 170 for any amount excluded from gross income under this provision.

1. The exclusion is only available for distributions from traditional and Roth IRAs and not for distributions from employer sponsored retirement plans, SEPs, Keoghs, 403(b) plans, 401(k) plans, SIMPLE IRAs, or profit sharing plans.
  2. Distributions must be made directly from the IRA trustee or administrator to the qualified charitable organizations.
  3. The exclusion only applies if the entire amount distributed would have been allowable as a charitable deduction (without regard to the percentage limitations) if contributed by the donor. Thus, the donor cannot receive any benefits from the charity as a result of the transfer or the exclusion from gross income will not be available. The charity will be required to provide written substantiation of receipt of an IRA distribution and that no goods or services were provided.
  4. The donor must actually have attained age 70 ½ before the distribution is made.
  5. If the donor's IRA contains both deductible and nondeductible contributions, the charitable rollover will be deemed to have been made from the deductible (and therefore taxable) portion first.
  6. The charitable IRA rollover may be beneficial for taxpayers who do not itemize, who are subject to certain percentage limitations such as for medical expenses, whose state does not allow a charitable deduction, or who are receiving social security.
  7. The charitable IRA rollover will count as against the taxpayer's required minimum distribution for the year of the rollover.
  8. In IRS Notice 2007-7, the Internal Revenue Service clarified several issues under these new rules.
- B. Split-Interest Trust Returns. The Act increases the penalty on split-interest trusts for failure to file returns and for failure to include required information or correct information. Split-interest trusts include charitable remainder trusts under section 664 and charitable lead trusts. The penalty is \$20 per day up to \$10,000 per return. If the trust has gross income over \$250,000, the penalty is \$100 per day up to \$50,000 per return. In addition, the Act imposes a personal penalty in

the same amount on persons with a duty to file split-interest trust returns if such person knowingly fails to file such returns. The exception to the filing requirement for split-interest trusts that are required to distribute all of their net income currently is repealed. These provisions are effective for returns for taxable years beginning after 2006.

C. Contributions of Food Inventory. The Act extends the enhanced deduction rules currently available for all trades and businesses for donations of food inventory through 2007. This enhanced deduction allows a deduction equal to the lesser of (1) the taxpayer's basis plus one-half of the difference between the fair market value and the basis and (2) twice the taxpayer's basis in the contributed food inventory. To qualify for the enhanced deduction the property must be inventory contributed to a section 501(c)(3) organization (other than a private foundation) and the donee must:

1. Use the property consistent with its exempt purpose for the care of the ill, needy, or minors;
2. Not transfer the property in exchange for cash, property, or services;
3. Provide the donor with a written statement that the donee's use will be consistent with these rules.

If the inventory is subject to the Federal Food, Drug and Cosmetic Act, the property must satisfy the applicable requirements of such act on the date of the contribution and for 180 days before the transfer. The donor must reduce its cost of goods sold by the lesser of the fair market value of the inventory or the donor's basis in the property. The donor must also establish that the fair market value of the property exceeds its basis.

D. S Corporation Stock Basis Adjustment. The Act conforms the S corporation rules to the partnership rules by providing that the amount of a shareholder's basis reduction in the stock of an S corporation by reason of a charitable contribution made by the corporation will be equal to the shareholder's pro rata share of the adjusted basis of the contributed property (rather than by the shareholder's pro rata share of the amount of the contribution). This provision is effective for contributions made during 2006 and 2007.

E. Contributions of Book Inventory. The Act extends the current provisions allowing contributions of book inventory to public schools by a C corporation to qualify for an enhanced charitable deduction. Rules similar to those for the enhanced inventory deduction apply. A qualified book contribution is a gift of books to a public school that

provides education in any of grades K through 12 and maintains a regular faculty and curriculum and normally has a regular enrolled body of students in attendance at the place where the educational activities are normally carried on. This provision is effective for contributions made during 2006 and 2007.

- F. Unrelated Business Income Tax-Controlling Exempt Organizations. The Act modifies the rules of section 512(b)(13) regarding payments to controlling exempt organizations. Currently, certain payments, such as rents, royalties, annuities, and interest, that are paid to a tax-exempt organization by a taxable subsidiary controlled by the exempt organization are treated as unrelated business income and subject to the unrelated business income tax. The Act provides that certain organizations will not be required to treat these payments as unrelated business income. This provision is effective through 2007. The Act also requires exempt organizations to report certain amounts received from controlled organizations on their annual information returns. This reporting requirement is effective for all returns the due date of which (determined without regard to extensions) is after August 17, 2006.
- G. Contributions for Conservation Purposes. The Act increases the percentage limitation for certain gifts of qualified conservation contributions from 30 percent to 50 percent of adjusted gross income and increases the carryover from five to 15 years. In the case of a farmer or rancher, a qualified conservation contribution deduction is allowable up to 100 percent of the taxpayer's contribution base as long as the property is restricted in such a manner that the property remains available for a farming or ranching purpose. This additional restriction does not apply, however, to contributions made after 2005 and on or before August 17, 2006. Both corporate and noncorporate farmers and ranchers also have a 15-year carryover. An eligible farmer or rancher means a taxpayer (other than a publicly traded C corporation) whose gross income from the trade or business of farming is greater than 50 percent of the taxpayer's gross income for the tax year. These rules generally apply to contributions made in taxable years beginning after 2005 and before 2008. Notice 2007-50 provides guidance, in a question and answer format, on the percentage limitations that apply to an individual's qualified conservation contributions under the Act.

#### IV. GENERAL REFORM PROVISIONS.

- A. Charitable Participation in Life Insurance Transactions. While Senate Bill 2020 imposed a 100 percent excise tax on the taxable acquisition of any interest in an applicable insurance contract, which was defined as any life insurance, annuity, or endowment contract in which both a charitable organization and any person that is not a charitable organization have, directly or indirectly, held an interest in the contract

(even if not held at the same time), the Act instead requires certain reporting as prescribed by the Internal Revenue Service with respect to such applicable insurance contracts.

1. Acquisitions that must be reported are those acquired by the charity in as a direct or indirect interest in a contract that the charity knows or has reason to know is an applicable insurance contract if the acquisition is part of a structured transaction involving a pool of contracts.
  2. There are certain exceptions to the reporting requirements. The following do not have to be reported:
    - a. If each person (other than the charity) with an interest in the contract has an insurable interest in the insured without regard to the charity's interest in the contract.
    - b. If the charity's sole interest in the contract or each person other than the charity is as a named beneficiary.
    - c. If the sole interest in the contract of each person other than the charity is either (i) as a beneficiary of a trust holding an interest in the contract if the designation as a beneficiary was gratuitous, or (ii) as a trustee who hold an interest in the contract as a fiduciary solely for the benefit of charities or persons who meet one of the other exceptions above.
  3. These rules do not apply to reportable acquisitions occurring after the date that is two years after August 17, 2006. These rules generally apply to acquisitions of contracts made after August 17, 2006.
  4. The Internal Revenue Service is directed to undertake a study of the use of applicable insurance contracts by charitable organizations and report to the Senate Finance Committee and the House Ways and Means Committee not later than 30 months after August 17, 2006.
  5. IRS Notice 2007-24 requested public comments on two new forms, Form 8921 and Form 8922, which are to be used to satisfy this reporting requirement and will also be used to gather data for the Internal Revenue Service study.
- B. Excise Taxes Applicable to Public Charities, Social Welfare Organizations, and Private Foundations.
1. For private foundations, the Act increases the initial tax on an act of self-dealing involving a private foundation from five percent to

10 percent and doubles the initial tax on a foundation manager who participates in an act of self-dealing from 2 ½ percent to five percent with an aggregate cap of \$20,000 instead of \$10,000.

2. The Act doubles the cap on the excise tax applicable to foundation managers who participate in an excess benefit transaction from \$10,000 to \$20,000. The excess benefit transaction rules apply to organizations described in sections 501(c)(3) (other than private foundations) and 501(c)(4).
3. The Act also doubles the initial taxes under the minimum distribution rules (from 15 percent to 30 percent), excess business holding rules (from five percent to 10 percent), jeopardy investment rules (from five percent to 10 percent), and taxable expenditure rules applicable to private foundations (from 10 percent to 20 percent). It also doubles the taxes and the caps applicable to foundation managers under the jeopardy investment rules and taxable expenditure rules.
4. These provisions are effective for taxable years beginning after August 17, 2006.

C. Charitable Contributions of Façade Easements.

1. The Act allows a charitable deduction for an easement on a building located in a registered historic district as long as the easement preserves the entire exterior of the building (including the front, sides, rear, and height of the building) and prohibits any change in the exterior that is not consistent with the historical character of the easement.
2. The taxpayer and the donee must enter into an agreement with certain certifications including a certification, under the penalties of perjury, that the donee has the resources to manage and enforce the restriction and a commitment to do so.
3. For any contribution made after August 17, 2006, in order to claim a charitable deduction the taxpayer must include with the taxpayer's return for the year of the contribution a qualified appraisal of the façade easement, photographs of the entire exterior of the building, and a description of all restrictions on the development of the building.
4. These rules apply to contributions made after July 25, 2006.
5. In addition, the taxpayer is required to pay a \$500 filing fee in the year of the contribution if the deduction is \$10,000 or more, which is to be used for the enforcement of these provisions. This

provision is effective for contributions made 180 days after August 17, 2006.

6. The Act also provides that the charitable deduction for a façade easement is reduced if the taxpayer has also claimed a rehabilitation tax credit with respect to the property. This rule applies to contributions made after August 17, 2006.
- D. Contributions of Taxidermy Property. The Act modifies the rules for charitable contributions of taxidermy property to eliminate past abuses in this area. Taxidermy property is defined as any work of art that is the reproduction or preservation of an animal, in whole or in part, is prepared, stuffed, or mounted for purposes of recreating one or more characteristics of the animal, and contains a part of the body of the dead animal. The Act denies capital gain treatment for this property for any person who prepared, stuffed, or mounted the property or for any person who paid or incurred the cost of such preparation, stuffing, or mounting. Further, the basis in such property is limited to the cost of preparing, stuffing, or mounting the property. Indirect costs such as costs of transportation for any aspect of the taxidermy or the hunting of the animal and the costs related to the hunting or killing of the animal may not be included in basis. These rules apply to contributions of taxidermy property made after July 25, 2006.
- E. Contributions of Related Use Tangible Personal Property.
1. Currently, a donor is entitled to a charitable deduction equal to the greater of fair market value or basis for a contribution of tangible personal property the use of which is related to the donee's exempt purpose. If the property is not related, the donee's deduction is limited to the property's basis (or fair market value if less).
  2. The Act treats as unrelated use tangible personal property that is sold, exchanged, or otherwise disposed of by the donee before the last day of the taxable year in which the donor made the contribution and with respect to which the donee has not in a written statement signed by an officer of the donee under the penalties of perjury either (1) certified that the use of the property was related to the donee's exempt purpose or function and described how the property was used and how such use furthered such purpose or function of the donee or (2) stated the intended use of the property by the donee at the time of contribution and certified that such use has become impossible or infeasible to implement.
  3. If the property is disposed of after the close of the taxable year of the contribution and within three years of the date of the

contribution (unless the donee makes the certification described above), the Act requires the recapture of the charitable deduction in an amount equal to the difference between the amount claimed as a deduction and the property's basis. The donor must include this amount in ordinary income in the year in which the disposition occurs.

4. The rule applies to property that was identified as related use property by the donee on Form 8283 and for which a deduction of more than \$5,000 is claimed by the taxpayer.
5. The Act also imposes a \$10,000 penalty (in addition to any criminal penalties) on any person who identifies property as exempt use property knowing that the property is not intended for such a use.
6. The Form 8282 reporting requirements for a sale by the charity (of any type of property for which Form 8283 was required) are increased to three years. In addition, the charity must provide a description of its use of the property, a statement whether this use was related to its exempt purpose, and, if applicable, a certification of any such use.
7. The recapture provisions apply to contributions made after September 1, 2006. The penalty provisions apply to identifications of property made after August 17, 2006.

F. Contributions of Clothing and Household Items.

1. The Act denies a deduction for any contribution by an individual, corporation, or partnership of clothing or a household item unless such item is in good used condition or better. Further, the Internal Revenue Service may, by regulation, deny a deduction for any contribution of clothing or a household item of minimal monetary value.
2. These limitations do not apply to any contribution of a single item for which a deduction of more than \$500 is claimed if the taxpayer includes with the taxpayer's return a qualified appraisal of the item.
3. Household items include furniture, furnishings, electronics, appliances, linens, and similar items. Food, paintings, antiques, and other art objects, jewelry, gems, and collections are not included within these rules.

4. In the case of a partnership or S corporation, these rules are applied at the entity level, but the deduction is denied at the partner or shareholder level.
  5. These rules apply to contributions made after August 17, 2006.
- G. Modified Recordkeeping Requirements for Cash Gifts.
1. A taxpayer may not claim a deduction for any cash or other monetary gift (even if under \$250) unless the taxpayer maintains as a record of the contribution a bank record (such as a cancelled check or credit card record) or other written communication from the donee showing the name of the donee, the date of the contribution, and the amount of the contribution. This provision applies to contributions made in taxable years beginning after August 17, 2006. Thus, calendar year taxpayers will be subject to these rules beginning in 2007.
  2. IRS Notice 2006-110 sets forth guidance for the new recordkeeping requirements in the case of charitable gifts made through payroll deductions.
- H. Contributions of Fractional Interests in Tangible Personal Property.
1. The Act generally denies an income tax and gift tax charitable deduction for an undivided portion of a donor's entire interest in tangible personal property unless all interests in the property are held by the taxpayer or the taxpayer and the donee immediately before the contribution. The Internal Revenue Service may, by regulation, provide exceptions to the general rule for situations where all persons who hold an interest in the property make proportional contributions of an undivided interest.
  2. The Act provides that in the case of any contribution of additional interests in the property, the deductible amount is the lesser of the fair market value of the property at the time of the initial contribution of a fractional interest and the fair market value of the property at the time of the contribution. For gift tax purposes, this may result in a taxable gift (or use of the donor's exemption amount) if the property has continued to appreciate since the initial gift. Similar rules apply for estate tax purposes where the decedent made fractional interest contributions before death, which may result in the payment of estate taxes on property passing to the charity.
  3. The new rules require that any charity that receives a fractional interest in tangible personal property must take complete ownership of the property within 10 years or upon the death of the

donor, whichever occurs first. In addition, the charity must have had substantial physical possession of the property during the 10-year period as long as the donor is living and used it in connection with its exempt purpose. If the donor is no longer in existence, the donation may be made to another charity.

4. If these rules are not met, the Act requires recapture of the tax benefits associated with the contribution, plus interest, and imposition of a 10- percent penalty tax on the amount of the recapture. Recapture rules, as well as a 10-percent penalty tax, also apply for purposes of the gift tax. Also, the gift is subject to the related use rules enacted by the Act.
5. These rules apply to contributions, bequests, and gifts made after August 17, 2006. The first fractional gift made after August 17, 2006 for property in which a prior fractional interest gift was made will be treated as the initial fractional contribution for purposes of the new law.

I. Substantial and Gross Overstatement of Valuations of Property.

1. The Act lowers the thresholds for imposing the accuracy-related penalty and eliminates the reasonable cause exception for gross misstatements. A substantial valuation misstatement occurs when the claimed value of property is 150 percent or more of the amount determined to be the correct value. A gross valuation misstatement occurs when the claimed value is 200 percent or more of the amount determined to be the correct value. For estate and gift tax purposes, a substantial valuation misstatement exists when the claimed value is 65 percent or less of the correct value and a gross valuation misstatement exists when the claimed value is 40 percent or less of the correct value.
2. The Act establishes a civil penalty on any person who prepares an appraisal that is to be used to support a tax position if the appraisal results in a substantial or gross valuation misstatement. The penalty is equal to the greater of \$1,000 or 10% of the understatement of tax resulting from the misstatement, up to a maximum of 125% of the gross income derived from the appraisal unless the appraiser can establish that the value established in the appraisal was more likely than not the proper value.
3. The Act eliminates the prior law requirement that the Internal Revenue Service assess a civil penalty against an appraiser for aiding and abetting the underpayment of tax before the appraiser may be subject to disciplinary action.

4. These new valuation rules are not limited to valuations for charitable deduction purposes.
5. The Act also defines a qualified appraiser and a qualified appraisal for purposes of section 170, which had previously been defined by regulation but not in the Internal Revenue Code. A “qualified appraisal” is an appraisal prepared by a qualified appraiser following accepted appraisal standards and any applicable Treasury regulations or other guidance. A qualified appraiser is an individual who:
  - a. Has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements to be established by the Internal Revenue Service in regulations;
  - b. Regularly performs appraisals for compensation;
  - c. Can demonstrate verifiable education and experience in valuing the type of property for which the appraisal is being performed;
  - d. Has not been prohibited from practicing before the Internal Revenue Service by the Treasury at any time during the three years before the appraisal; and
  - e. Is not excluded from being a qualified appraiser under any applicable Treasury regulations.
6. The valuation misstatement penalties apply to returns filed after August 17, 2006. The appraiser provisions apply to appraisals prepared with respect to returns or submissions filed after August 17, 2006. In the case of façade easements, however, the rules apply to returns filed after July 25, 2006.
7. IRS Notice 2006-96 sets forth additional guidance on the appraisal requirements for noncash charitable contributions under the Act, including some transactional guidance regarding the definition of “qualified appraisal” and “qualified appraiser.”
- J. Additional Standards for Credit Counseling Organizations. The Act establishes additional exemption standards for credit counseling organizations.
- K. Tax on Private Foundation Net Investment Income. The Act expands the definition of gross investment income for purposes of computing the tax imposed on a private foundation’s net investment income. Net investment income will also include income from sources that are

similar to those set forth in section 4940, such as annuities, notional principal contracts, and similar investment income. It also will include gains from the sale of property held for the production of gross investment income and not just property held for the production of interest, dividends, rents, and royalties. Private foundations will also be able to exclude capital gain from net investment income for exempt use property if the property has been used in an exempt purpose for at least one year before its disposition and is exchanged for like-kind property under rules similar to those set forth in section 1031. The change is effective for taxable years beginning after August 17, 2006.

- L. Definition of Convention or Association of Churches. The Act clarifies the definition of a convention or association of churches to make it clear that an organization will not fail to be a convention or association of churches merely because the membership includes individuals as well as churches or because individuals have voting rights.
  
- M. Notification Requirements for Organizations Not Required to File an Annual Return.
  - 1. An organization that is not required to file an annual return because its gross receipts are normally below the threshold for filing (currently \$25,000) is required to make an electronic filing annually of certain information which will include (1) the organization's legal name and any assumed names, (2) the organization's mailing address and Internet web site address, if any, (3) the organization's taxpayer identification number, (4) the name and address of a principal officer of the organization, and (5) evidence of the continuing basis for the organization's exemption from the annual filing requirements. Any such organization that ceases to exist is also required to provide notice of such termination. There is no financial penalty, however, for failing to make this filing. These rules apply to notices with respect to annual periods beginning after 2006.
  
  - 2. Beginning 2008, organizations subject to this notification requirement will be required to file Form 990-N electronically. The Internal Revenue Service plans to mail educational letters to those organizations beginning in July 2007.
  
- N. Loss of Exempt Status for Failure to Make Annual Return or Notification. Any organization that fails to file an annual return or provide the annual notice now required by the Act for three consecutive years will be considered as having had its exempt status revoked as of the date the third annual return or notice was due to be filed. The Internal Revenue Service must publish and maintain a list of the organizations whose exemption is revoked under this provision. Any

organization seeking reinstatement must apply to the Internal Revenue Service (even if a filing was not originally required by the organization). The reinstatement may be retroactive if the failure to file was due to reasonable cause. These rules apply to notices and returns with respect to annual periods beginning after 2006.

- O. Disclosure to State Officials. The Internal Revenue Service may disclose to an appropriate state official upon written request by such state official information regarding organizations for which the Internal Revenue Service has denied or revoked tax-exempt status, the issuance of a letter of proposed deficiency of tax under certain provisions applicable to exempt organizations, the names, addresses, and taxpayer identification numbers of organizations that have applied for recognition of exemption under section 501(c)(3), and returns filed by tax-exempt organizations. These disclosures may only be made for the purpose of, and to the extent necessary in, the administration of state laws regulating such organizations. The Internal Revenue Service also has the discretion to make these disclosures upon its own initiative if it determines that there may be evidence of noncompliance with state laws. The Internal Revenue Service may also make available for inspection or disclosure returns of an organization exempt under section 501(c) other than 501(c)(1) or (c)(3) for the purpose of, and only to the extent necessary for, the administration of state laws regulating solicitation or the administration of charitable funds or charitable assets of such organizations. Appropriate state officers are defined to include a state attorney general, a state tax officer, a state official charged with overseeing section 501(c)(3) organizations, or, for solicitation purposes, the head of an agency designated by the state attorney general as having primary responsibility for overseeing the solicitation of funds for charitable purposes. These changes are effective as of the August 17, 2006 but will not apply to any requests made before August 17, 2006.
  
- P. Public Disclosure of Form 990-T. In the case of a section 501(c)(3) organization only, the Act extends the public inspection and disclosure requirements and penalties to Form 990-T, which is the return upon which an organization's unrelated business taxable income is reported. This provision applies to returns filed after August 17, 2006. IRS Notice 2007-45 provides interim guidance on the required public disclosure of Form 990-T.

## V. TAX RELIEF AND HEALTH CARE ACT OF 2006

- A. Prior Law of Charitable Remainder Trusts with UBTI. Under prior law, a charitable remainder trust lost its exempt status under Internal Revenue Code section 664 for any year in which the trust had unrelated business taxable income, even if such income was de minimis.

B. New Rules for Charitable Remainder Trusts. The Tax Relief and Health Care Act of 2006 was signed into law on December 20, 2006. This Act made significant changes to the tax treatment of charitable remainder trusts that have unrelated trade or business income.

1. Under the new law, the receipt of unrelated business taxable income does not cause loss of exempt status. Instead, the charitable remainder trust is subject to an excise tax equal to 100 percent of the amount of the unrelated trade or business income.
2. This change was effective January 1, 2007.