# Pension Protection Act of 2006: Provisions of Interest to Exempt Organizations

On August 17, 2006, President Bush signed H.R. 4, the Pension Protection Act of 2006 (the "Act"), into law. The Act's 900-plus pages include significant provisions aimed at both stimulating charitable donations as well as curbing perceived abuses by exempt organizations and taxpayers claiming charitable contribution deductions. The following summary highlights some of the key provisions pertaining to exempt organizations and their donors.

## I. <u>Charitable Giving Incentives and Reforms</u>

### <u>Charitable Giving Incentives</u>

- **Tax-Free Distributions from IRAs for Charitable Purposes**. Long sought by charities, the Act includes a significant new IRA charitable rollover provision. Expected to generate up to $400 million in charitable giving over the next two years, this rule allows taxpayers aged 70 ½ years or older to exclude from gross income annual charitable donations of up to $100,000 from traditional or Roth individual retirement accounts ("IRAs"). Currently, this provision applies to contributions made in 2006 and 2007. Note, however, that split-interest gifts (including charitable remainder trusts), as well as contributions to donor advised funds, supporting organizations, and private non-operating foundations, are not eligible to take advantage of this exclusion.

- **Charitable Deduction for Contributions of Food and Book Inventory**. The Act extends certain charitable deduction provisions, first enacted as part of the Katrina Emergency Tax Relief Act of 2005, pertaining to contributions of food and book inventory. Under the Act, the taxpayer may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's fair market value in excess of basis, or (2) two times basis. The enhanced deduction for contributions of book inventory applies only to contributions made by C corporations to public elementary and secondary schools. By contrast, any taxpayer engaged in a trade or business may claim the enhanced deduction for contributions of food inventory. These provisions remain effective for contributions made before January 1, 2008.

- **Tax Treatment of Payments from Controlled Subsidiaries.** The Act revises the tax treatment of certain payments made by controlled subsidiaries to parent exempt organizations. The provisions in the Act are very limited in scope, applying generally only to payments made pursuant to written agreements that were in effect as of the date of enactment of the Act. Under this provision, applicable payments made in the form of interest, rent, annuity or royalty may be treated as not taxable by the recipient parent exempt organization to the extent such payments do not exceed fair market value (as determined according to the principles of Internal Revenue Code of 1986 ("Code") Section 482). Further, the Act imposes an excise tax penalty of 20 percent of the value of any payment amounts that exceed fair market value. The Act calls for the Department of Treasury to submit a report to Congress not later than January 1, 2009 on the effectiveness of Internal Revenue Service administration of this provision.

- **Incentives to Donate Property for Conservation Purposes**. The Act increases the charitable deduction limit – from 30% of adjusted gross income to 50% of that figure – for qualified contributions of real property made for conservation purposes. The provision applies to contributions of real property made by individuals before January 1, 2008. Excess contribution amounts may be carried forward up to 15 years.

- **Other Charitable Giving Incentives**. The Act includes a number of charitable giving incentives of more limited application. Examples include a provision dealing with the adjustments made to the basis of stock of S corporations that contribute stock to a charity, and exemption from certain retail and manufacturers excise taxes for qualified blood collector organizations.

## Charitable Giving Reforms

The Act also institutes a number of important charitable giving reforms. For example, the Act increases the maximum amounts of certain excise taxes that may be imposed on public charities, social welfare organizations, and private foundations. The Act also tightens certain rules that govern real property donations. Furthermore, with an eye toward increasing the transparency and accountability of charities, the Act imposes new disclosure and reporting requirements on exempt organizations.

- **Increased excise taxes for violating private foundation rules**. Private foundations are exempt under Section 501(c)(3), but are subject to stricter compliance requirements than those applicable to public charities. Specifically, private foundations must pay a 2% tax on their annual net investment income; they may not engage in various transactions with related parties, described broadly as "self-dealing"; they must distribute at least 5% of their net income for charitable purposes; they may not hold significant ownership interests in other entities; they may not engage in overly risky investments; and they may not expend funds for other than charitable purposes. The Code imposes excise taxes on private foundations (as well as, in some instances, individual insiders engaging in self-dealing and on responsible foundation managers) that do not comply with these requirements. The Act has now doubled each of these excise taxes, as they may apply to self-dealers, foundation managers, and the private foundations. Moreover, the maximum dollar amounts allowed to be charged per act or transaction by the Code were increased by the Act as well.

- **Increased excise taxes for excess benefit transactions.** The Code also includes a two-tiered excise tax for "excess benefit transactions," described broadly as abusive transactions between charitable or social welfare organizations and "disqualified persons" (individuals or entities closely affiliated with such organizations). The Act doubles the maximum dollar amount of the initial and additional taxes that may be imposed on organizational managers who knowingly and willfully approved excess benefit transactions, from $10,000 to $20,000 per transaction.

- **Recapture of tax benefit on property not used for an exempt use**. Generally, donors may deduct, as a charitable contribution, the fair market value of tangible personal property that they contribute to a charitable organization for use in furtherance of the organization's exempt purposes. However, for deductions of more than $5,000, the Act stipulates that donors may take the full fair market value deduction only if the recipient public charity or private operating foundation uses the property for three years. Alternatively, the recipient charity may use the property for a shorter period, but it must provide both the donor and the IRS with a statement indicating that such continued use was impossible or infeasible to implement. If the organization disposes of the property within three years and fails to provide such certification, the donor must reduce the value of the charitable deduction to cost basis. Any amount realized on sale of the property by the charitable organization will be regarded as relevant to a determination of fair market value.

- **Limitations on donations of clothing and household items**. The Act disallows charitable deductions for contributions of clothing and household items unless the clothing or household items are "in good used condition or better." Household items include furniture, electronics, appliances, linens, and similar items, but do not include food, paintings, antiques, art, jewelry, gems, and collections. Moreover, the Act requires that a donor include a qualified appraisal with its tax return in order to take a deduction of more than $500 for any contribution of any clothing or household item that is not in good used condition or better. The Act also allows Treasury to deny a deduction for any item with minimal monetary value.

- **Penalties imposed for incorrect valuations of property and appraisals**. For certain charitable deductions, taxpayers must furnish a qualified appraisal. The Act lowers the threshold at which the IRS may impose penalties for inaccurate appraisals. If a taxpayer furnishes the IRS with a "substantial valuation misstatement," defined as a valuation that is at least 150% of the correct value, the IRS will now impose a 20% penalty on the underpayment of tax. For a "gross valuation misstatement," defined as a valuation of at least 200% of the true value, the IRS will now impose a 40% penalty on the underpayment. Moreover, the Act has eliminated the "reasonable cause" defense that taxpayers could previously posit for gross valuation misstatements. Similarly, the Act lowers the threshold for what constitutes a "substantial estate or gift tax valuation misstatement," defining that term as any valuation that is 65% or less of the correct amount. The Act deems an undervaluation of 40% or less to constitute a "gross estate or gift tax valuation misstatement." In addition to penalizing the taxpayers who report these defective valuations, the Act also fines those professionals who prepare such appraisals, unless the applicable appraiser can establish that the appraisal was "more likely than not" correct.

- **Donor record-keeping requirements**. The Act provides that donors claiming charitable contribution deductions must maintain record of any cash contribution. Such records include either a cancelled check or written acknowledgment from the charitable organization showing the name of the organization as well as the date and amount of the contribution.

- **Contributions of fractional interests in tangible personal property**. The Act restricts charitable deductions for fractional interests in personal property. If a donor initially contributes a fractional interest in tangible personal property (such as a 50% interest in a work of art), and the donor subsequently fails to contribute the remaining interest in the property to the same charitable organization within the shorter of 10 years from the initial contribution or upon the donor's death, then the donor will lose all previous charitable income and gift tax deductions, as well as incur interest and penalties. The Act also provides that if the charitable organization fails to take substantial physical possession of the item or fails to use the property for an exempt purpose during the same period, then the donor's charitable income and gift tax deductions will be recaptured, along with interest and penalties. Assuming that a donor does proceed to donate the remaining interest(s) in the property, the value of any such subsequent contribution will be the lesser of (1) the value used for purposes of determining the charitable deduction for the initial fractional contribution, or (2) the fair market value of the item at the time of the subsequent contribution. The provision applies for income, gift, and estate tax purposes.

- **Disclosure and reporting requirements**. The Act requires Section 501(c)(3) organizations to publicly disclose their unrelated business income tax returns (Form 990-T) in the same manner that all exempt organizations must make their Forms 990 publicly available. Furthermore, although organizations with annual gross receipts of $25,000 or less need not file annual returns (Form 990), the Act requires such organizations now to file an annual electronic notice with the IRS disclosing certain basic identifying information, including the organization's legal name, any name under which it operates or does business, its mailing address and website (if any), its taxpayer identification number, the name and address of a principal officer, and evidence of its continuing basis for exemption from filing Form 990. This electronic notice will be publicly available. Organizations failing to file such electronic notice or Form 990 for three consecutive years will have their tax-exempt status revoked. Finally, the Act also permits the IRS to disclose to state officials, upon request: (1) a notice of proposed refusal to recognize an organization as a Section 501(c)(3) organization; (2) a notice of proposed revocation of tax-exemption of a Section 501(c)(3) organization; (3) the issuance of a proposed deficiency of tax; (4) the names, addresses, and taxpayer identification numbers of organizations that have applied for recognition as Section 501(c)(3) organizations; and (5) returns of organizations with respect to which information has been disclosed under (1) through (4) above.

## II. Donor Advised Funds and Supporting Organizations

The Act institutes significant new guidelines for donor advised funds and supporting organizations, particularly "Type III" supporting organizations. As a general matter, the Act requires the Secretary of the Treasury to undertake a study of both of these types of entities, with a preliminary report due one year following passage of the Act. While the Act takes the first steps in tightening the oversight of donor advised funds and supporting organizations, the mandated Treasury study suggests that this process will likely continue beyond the provisions contained in H.R.4.

### Donor Advised Funds

The Act creates two new Code sections regarding donor advised funds, and under the new Section 4966, the Code statutorily defines donor advised funds as comprising three elements:

- The fund is separately identified by reference to contributions of a donor or donors;
- The fund is owned and controlled by a "sponsoring organization" and
- The fund is such that a donor (or a donor's designee) has or reasonably expects to have advisory privileges with respect to the distribution or investment of amounts held in the fund.

To satisfy the first element, the sponsoring organization must maintain the fund account separate from its general fund. The donor advised fund account must also be identifiable by reference to its originating contributions. An easy and obvious way to fulfill this identification requirement is for the fund to be named after the donor, such as "The John Smith Donor Advised Fund." However, other means may exist for fulfilling this identification requirement.

For purposes of the definition's second element, a "sponsoring organization" is a public charity (*i.e.*, an entity exempt from federal income tax under Section 501(c)(3) of the Code, with a broad contributor base) that maintains one or more donor advised funds.

Finally, the definition's third prong contemplates a facts-and-circumstances analysis of whether a donor maintains a reasonable expectation of advisory privileges over the fund's assets. Means of establishing such reasonable expectations might include stipulated provisions in a written document between the donor and the sponsoring organization, or particular conduct by both parties that creates such an expectation. In all events, a donor advised fund may not create a legal right to *compel* specific distributions from the fund; at most, the donor enjoys *advisory* privileges that the sponsoring organization may, in its independent discretion, consider and choose to follow. The sponsoring organization at all times exercises control over the funds. This control enables the donor to take the charitable deduction "up front," at the time of the fund creation, rather than as the sponsoring organization makes distributions from the fund.

Beyond its statutory definition of donor advised funds, the Act institutes several restrictions on the operation and activity of these funds. These include the following:

- Only certain types of tax-exempt entities may operate donor advised funds that offer a charitable deduction to the donor.
- The "excess business holding" rules of private foundations (discussed above) apply to donor advised funds.
- Certain transactions between the donor and the donor advised fund now constitute "automatic" excess benefit transactions.
- Donor advised funds may not engage in "taxable distributions" (*i.e.*, distributions to individuals or to organizations other than public charities, unless the distributing organization performs oversight – known as "expenditure responsibility" – over the grant).
- Donor advised funds incur a severe excise tax for any distribution that directly or indirectly benefits the donor any more than an incidental amount.

Finally, and significantly, the Act requires that all "sponsoring organizations" disclose on their annual tax returns how many donor advised funds they own; the aggregate value of the assets held in those funds; and the aggregate contributions to the funds as well as the grants made from such funds.

**Supporting Organizations**

There are three different types of supporting organizations that exist under Section 509(a)(3). All share the common attribute of providing (through various means) "support" to other public charities or other publicly supported organizations that are recognized as exempt under Code Section 501(c)(4), (5), or (6). However, the form of such support varies, and the Act pays particularly rigorous attention to "Type III" supporting organizations.

A “Type III” supporting organization is one that is “operated in connection with” one or more public charities. This means that the supporting organization must be responsive to, and involved in the operations of, the supported organization. Under the Act, certain “Type III” supporting organizations will be subject to the “excess business holdings” discussed above with regard to private foundations. Furthermore, “Type III” supporting organizations will no longer be allowed to support organizations that are organized outside of the United States. Finally, “Type III” supporting organizations will be required to provide information to their supported organizations, as required by the Secretary of the Treasury, in order to ensure their ongoing responsiveness to the needs of their supported organizations.

The Act also directs the Secretary of the Treasury to promulgate new regulations that establish a minimum distribution requirement for “Type III” supporting organizations, distributable in either income or assets.

In addition to its provisions that apply uniquely to “Type III” supporting organizations, the Act establishes certain rules that pertain to all supporting organizations. These include application of the “automatic” excess benefit transaction rules for grants, loans, or various payments by a supporting organization to one or more of its substantial contributors; heightened disclosure standards that require all supporting organizations, regardless of income level, to submit an annual Form 990; and a definitional standard that treats a “disqualified person” of a supporting organization as a “disqualified person” of the supported organization(s) as well.

The provisions described above are brief summaries of at-times complex provisions of the new law.  Please contact any of the following members of Venable for assistance or with any questions:


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