

# Charity-Related Provisions of the Pension Protection Act of 2006: Significant New Rules and Restrictions

September 2006

# Charity-Related Provisions of the Pension Protection Act of 2006: Significant New Rules and Restrictions

On August 17, 2006, President Bush signed H.R. 4: The Pension Protection Act of 2006 (the Pension Act), P.L. 109-280. The Pension Act makes numerous significant changes to federal tax law affecting charitable giving and the operation of tax-exempt charitable organizations. Indeed, many have characterized the Pension Act as the most sweeping legislation to affect charities since the Tax Reform Act of 1969, which imposed the current regulatory regime for private foundations and public charities (including supporting organizations). This white paper is intended to summarize the most significant portions of the Pension Act. Our purpose is to highlight the most important issues that will be relevant to charities and charitable giving rather than providing a thorough discussion of the changes in the law arising from the Pension Act. This should outline for you and your advisors the impact this new legislation has on your activities. Our discussion is broadly divided into five main sections:

- New Rules Affecting Charitable Giving
- New Reporting, Unrelated Business Income and Intermediate Sanctions Rules
- Tougher Rules for Private Foundations
- Tougher Rules for Supporting Organizations
- New Rules Affecting Donor-Advised Funds

## New Rules Affecting Charitable Giving

### IRA DISTRIBUTIONS TO CHARITY

The Pension Act includes long-sought provisions allowing taxpayers to exclude from income amounts distributed to charity from individual retirement accounts (IRAs). Specifically, the new law provides that a taxpayer who has attained age 70½ may distribute up to \$100,000 per year to any public charity (other than any donor-advised fund or supporting organization), and may exclude the amount of that distribution from gross income for federal income tax purposes. Moreover, the amount of any IRA distribution to charity that is excluded from income will be counted towards that taxpayer's required IRA distributions and will not be considered for purposes of determining the taxpayer's charitable contribution percentage limitation (*i.e.*, the ceiling on allowable charitable deductions generally calculated as a percentage of adjusted gross income). In short, the Pension Act allows a taxpayer using IRA proceeds to make charitable contributions of up to \$100,000 per year to be counted towards the taxpayer's required distributions. While a deduction is not allowed for those contributions, the distribution from an IRA will not be taxable to the taxpayer as income and will not affect the deductibility of other contributions under Internal Revenue Code (the Code) Section 170. This provision will remain in effect through December 31, 2007. This new giving incentive may be particularly helpful to taxpayers seeking to satisfy or accelerate payment of charitable pledges.

### EXTENSION OF CERTAIN KATRINA RELIEF PROVISIONS

The Katrina Emergency Tax Relief Act of 2005 created several incentives to increase charitable giving effective through December 31, 2006. Among the incentives were provisions that provided certain taxpayers with enhanced deductibility for contributions of items such as inventory. Generally, contributions of inventory and other items of ordinary income property may be deductible to the extent of the lesser of the taxpayer's basis in, or the fair market value of, the contributed property. Certain provisions in the Katrina Act allowed deductions for charitable contributions equal to the "augmented basis" of the contributed property. "Augmented basis" is the lesser of (a) basis plus one-half of the contributed property's appreciation or (b) twice basis.

### Food Contributions

For instance, under the Katrina Act, any taxpayer engaged in a trade or business was entitled to deduct contributions of "apparently wholesome" food inventory at augmented basis for contributions made between August 28, 2005 and January 1, 2006. For taxpayers other than C corporations the amount deductible was limited to 10 percent of the taxpayer's income from all trades or businesses from which such contributions were made that year.

### Contributions of Book Inventory

The Katrina Act also provided for a deduction equal to augmented basis for contributions by C corporations of book inventory to public primary and secondary schools before December 31, 2005.

The Pension Act extends the Katrina Act for the provisions described above for contributions made after December 31, 2005 and before January 1, 2008.

### CONTRIBUTIONS FOR CONSERVATION PURPOSES

The Pension Act contains significant new incentives for taxpayers to make contributions of real property for “qualified conservation purposes.” Under both former and current law, these purposes include: the preservation of land areas for outdoor recreation by, or for the education of, the general public; the protection of natural habitats and other ecosystems; the preservation of open spaces for scenic enjoyment of the general public or pursuant to a clearly delineated governmental conservation policy; and the preservation of a historically important land area or certified historic structure. Gifts for these purposes include gifts of the entire interest of a donor in real property (other than a mineral interest), a remainder interest in real property, or a restriction granted in perpetuity (such as an easement) on the use of real property. A donor is entitled to a deduction for gifts of this type made to certain governmental units, public charities that meet certain public support tests and certain supporting organizations. The Pension Act provides that an individual may deduct qualified conservation contributions up to 50 percent of the contribution base, as opposed to former law which limited the deductibility of these contributions to 30 percent of the donor’s contribution base. A taxpayer who is a qualified farmer or rancher, however, may deduct up to 100 percent of that taxpayer’s contribution base, provided the contributed property remains available for use for farming or ranching purposes. This 100 percent limitation also applies to corporations other than publicly traded corporations that are qualified farmers or ranchers. Moreover, a taxpayer may “carry-forward” the amount of any unused contributions that exceed the 50 or 100 percent limitation for up to 15 years, as opposed to five years under former law. This provision applies to contributions made in taxable years beginning after December 31, 2005 and before January 1, 2008.

### MORE RESTRICTIVE RULES FOR CONSERVATION EASEMENTS FOR HISTORIC STRUCTURES

While the Pension Act creates greater incentives for taxpayers to make charitable contributions for qualified conservation purposes, it also creates new restrictions for taxpayers claiming charitable deductions for contributions of “façade” conservation easements on historic structures. Under former law, a taxpayer was permitted to deduct the “fair market value” of an easement that preserves the architectural, historic and cultural features of a historic structure’s façade. The Pension Act requires that in order to be deductible, any such easement must preserve not only the façade, but the entire exterior of the historic structure, including the space above the structure, its sides and rear, as well as its façade. Moreover, a qualified real property interest must ensure that no portion of the exterior of the building will be changed in a manner inconsistent with the historic character of the exterior. In addition, the Pension Act imposes more burdensome substantiation requirements for taxpayers claiming a charitable deduction for the contribution of a façade easement. Under these new disclosure requirements, the taxpayer must include with his or her income tax return for the year of contribution: a qualified appraisal of the qualified real property interest contributed regardless of the interest’s claimed value, photographs of the entire exterior of the structure, and descriptions of all current restrictions on the development of the structure. These restrictions include zoning laws, ordinances, association rules, restrictive covenants and similar restrictions. Any failure to provide this information will result in a disallowance of the deduction. Moreover, the donee charity must certify in an agreement with the taxpayer that the donee is a qualified organization organized for environmental or similar purposes, that it has the resources to manage and enforce the restriction, and that it commits to doing so. Any taxpayer claiming a deduction in excess of \$10,000 for the contribution to charity of a façade easement must pay a \$500 fee to the Internal Revenue Service (IRS), presumably to assist in funding the additional enforcement duties that the IRS will need to undergo in order to satisfy the Congressional intent of this new legislation. The Pension Act also provides that any deduction for a qualified conservation contribution for a historic purpose will be reduced by the amount of any rehabilitation credits claimed with respect to the donated property within the five preceding tax years. These changes in the tax law undoubtedly will have a negative impact on the number of taxpayers creating and contributing façade easements.

### CONTRIBUTIONS BY S CORPORATIONS

The Pension Act provides for a basis adjustment for shares of stock of an S corporation that contributes property to charity. Under former law, an S corporation shareholder’s basis in shares of the corporation would be reduced by the proportionate amount of the corporation’s charitable contribution that flows through to that shareholder, thereby effectively reducing the deduction’s economic value. Under the Pension Act, each shareholder’s basis in the corporation stock will be reduced by that

shareholder's *pro rata* share of the adjusted basis of the contributed property. Consequently, the shareholder's potential increase in capital gain as a result of the contribution is less than under former law. This provision applies to contributions made between December 31, 2005 and January 1, 2008.

#### DEDUCTION FOR CONTRIBUTIONS OF TAXIDERMY PROPERTY LIMITED TO BASIS

The Pension Act limits the deductibility of charitable contributions of "taxidermy property" that is long-term capital gain property to the lesser of basis or fair market value. (Because taxidermy property is tangible personal property, the donor's charitable contribution deduction would be limited to basis in any case unless the "related purpose" rule is met.) Taxidermy property includes any work of art that is the reproduction or preservation of an animal, in whole or in part, which is prepared, stuffed or mounted for purposes of recreating one or more characteristics of the animal, and that contains a body part of the dead animal. Generally, the basis of the contributed taxidermy property will include the cost of preparing, stuffing and mounting the animal. Indirect costs associated with creating the contributed property (such as travel costs to obtain or transport the property) are not included.

#### RECAPTURE OF TAX BENEFIT FOR CONTRIBUTION OF "RELATED-USE" PROPERTY NOT USED BY CHARITY

The Pension Act provides that a taxpayer's charitable contribution deduction for tangible personal property is limited to the lesser of the taxpayer's basis in the contributed property and its fair market value if the property is disposed of by the donee charity later that same tax year. This provision does not apply if the donee charity certifies either (a) that the contributed property was related to and used in furtherance of the donee's tax-exempt purposes (with a description of its use), or (b) that the intended use for tax-exempt purposes became impossible or infeasible to implement. In addition, the Pension Act requires the recapture of a portion of a donor's tax benefit realized for any charitable contribution of tangible personal property that is disposed of by the donee charity after the tax year of donation but before the third anniversary of the contribution unless, again, the donee charity executes the certification described above. If a certification is not executed, the recapture event requires the taxpayer to include in income, for the year in which the donee charity disposes of the contributed property, the difference between the amount of the deduction for that property and the basis of the contributed property at the time of contribution. The Pension Act also imposes a punitive fine of \$10,000 against any person who identifies tangible personal property as having a use which is related to a charity's tax-exempt purpose knowing that the property is not intended for such use. Finally, current law requires charities that dispose of donated property within two years to file a form with the IRS reporting the disposition. The Pension Act changes the reporting period to three years. These rules apply to contributions made after September 1, 2006.

#### STRICTER RULES FOR CHARITABLE CONTRIBUTIONS OF CLOTHING AND HOUSEHOLD ITEMS

Effective for contributions made after August 17, 2006, the Pension Act denies a charitable deduction for contributions of clothing or household items (including furniture, furnishings, electronics, appliances, linens and other similar items) to charity unless the clothing and items are in "good used" condition or better. Moreover, the Secretary of the Treasury is empowered to issue regulations denying a charitable deduction for any contribution of clothing or household items that have minimal monetary value. This rule will not apply to contributions of any single item of clothing or household item for which a deduction of more than \$500 is claimed provided the taxpayer includes with the tax return a qualified appraisal of the contributed property.

#### SUBSTANTIATION OF CERTAIN MONETARY GIFTS

The Pension Act requires that a taxpayer claiming a deduction for a monetary charitable contribution of any amount must retain a bank record or a written communication from the donee charity showing the name of the donee charity, the date of contribution and the amount of the contribution. This change in law effectively eliminates the deductibility of anonymous cash gifts, such as cash contributed to a church collection plate. This provision is effective for contributions made during tax years beginning after August 17, 2006.

#### NEW RESTRICTIONS FOR GIFTS OF PARTIAL INTERESTS IN TANGIBLE PERSONAL PROPERTY

The Pension Act imposes strict requirements on any taxpayer who claims a deduction for a gift to charity of a fractional interest in tangible personal property like artwork. Prior to the contribution of a fractional interest in tangible personal property, the donor, alone or in conjunction with the donee, must have owned all interests in the underlying items of tangible personal property. These new provisions require that the charity receiving the fractional interest must take complete ownership of the item of property through an "additional contribution" within 10 years or, if earlier, the death of the taxpayer contributing the property. If not, the benefit of the taxpayer's initial deduction will be subject to recapture. In addition, the charity must take substantial physical possession of the property and use the property in furtherance of its charitable purposes.

Further, the Pension Act also provides that any contribution to charity of the “additional contribution” will be valued based on *the lesser of* (i) the fair market value of the interest as of the date of the “initial contribution” or (ii) the fair market value as of the date of the additional contribution. Essentially, for income tax purposes, the combined value of all contributed fractional interests (both initial contribution and any additional contribution) in an item of tangible property cannot exceed (and may ultimately be less than) the fair market value of that item as of the date of the initial contribution. Surprisingly, the Pension Act provides that this method of valuing a fractional interest in tangible personal property will also apply in the estate tax and gift tax charitable contribution contexts. Thus, while a fractional interest in an item of tangible personal property (for which a fractional interest has already been contributed to charity) that is included in a decedent’s gross estate will be valued for such purposes at fair market value as of date of death, it appears for estate tax charitable deduction purposes that the same item will be valued in the manner described above. The differential between those values apparently will be subject to estate tax. The new provision also has similar serious implications under the gift tax. These provisions create a strong disincentive for taxpayers to make serial fractional charitable gifts of art and other items of tangible personal property. No taxpayer will want to take the chance that he or she will have to pay a gift or estate tax on any “additional gifts” simply because the contributed property has appreciated.

This provision applies for contributions made after August 17, 2006; however, according to the report prepared by the Joint Committee on Taxation discussing the Pension Act, contributions of partial interests in tangible personal property made before that date would not be treated as an initial contribution. This provision, then, does not apply to a subsequent gift of the remaining interest if the entire remaining interest is contributed in one gift.

## New Reporting, Unrelated Business Income and Intermediate Sanctions Rules

### REQUIRED INFORMATION FILING FOR SMALL EXEMPT ORGANIZATIONS NOT REQUIRED TO FILE FORM 990

Organizations that are normally excused from filing federal information returns because their gross receipts are under a specified amount (generally non-private foundations with receipts under \$25,000) are required each year under the Pension Act to send electronically the following information to the Secretary of the Treasury: the organization’s name, address, Internet address, employer identification number (EIN), name and address of the principal officer, and evidence of the continued basis for its exemption from filing Form 990. This requirement applies to all types of exempt organizations (for example, trade associations and social clubs), not just Section 501(c)(3) organizations. Unlike the failure to file a Form 990, the failure to file the new annual statement is not subject to a monetary penalty. As described below, however, the failure to file such return for three consecutive years may result in revocation of tax-exempt status. This requirement is effective for tax years beginning after 2006.

### REVOCAION OF EXEMPT STATUS FOR NON-FILING

The Pension Act provides that if an organization fails to file a Form 990 or 990-PF, as required, or, if not required to file, the organization fails to provide the annual information filing described above, for three consecutive years, the organization’s tax-exempt status will be revoked effective as of the due date for the third unfiled return or filing. If an organization’s exempt status is revoked under this provision, it must apply to the IRS to obtain reinstatement of its exempt status, regardless of whether it originally was required to file an application for recognition of exemption. Thus, for example, small Section 501(c)(3) organizations and non-Section 501(c)(3) exempt organizations that are technically not required to apply for recognition of exemption will have to apply for exemption if their exempt status is revoked under this provision. Reinstatement of the exemption may be retroactive to the date of revocation if the organization shows reasonable cause for the failure to file. This requirement is effective for tax years beginning after 2006.

### UNRELATED BUSINESS TAXABLE INCOME TAX RETURNS ACCESSIBLE BY THE PUBLIC

For Section 501(c)(3) organizations only, the Pension Act provides that tax returns reporting unrelated business income tax on a Form 990-T are subject to the same public inspection and disclosure requirements as apply to the Form 990. The new law provides that certain information, such as information related to trade secrets or patents, may be withheld by the charitable organization from disclosure if public availability would adversely affect the organization. The provision applies to Forms 990-T filed after August 17, 2006.

#### NEW DISCLOSURE RULES ALLOWING STATE INSPECTION

The Pension Act provides new disclosure rules that allow the IRS, upon request, to disclose to state agencies (such as an attorney general, tax officials or agencies overseeing solicitation of funds for charitable purposes) materials related to specific organizations, including: IRS notices of proposed refusal to recognize tax-exempt status, proposed revocation of tax-exempt status, or tax deficiency for excise taxes; names, addresses and tax identification numbers of charitable organizations seeking tax-exempt status; and materials related thereto. The purpose of these new disclosure rules is to assist state governments with the enforcement of their charitable laws related to tax-exempt status, charitable solicitation and consumer fraud.

#### UNRELATED BUSINESS TAXABLE INCOME ISSUES RELATED TO CONTROLLED ENTITIES

The Pension Act also changes, temporarily and only for binding written contractual relationships that were in effect on August 17, 2006, the current rule that a controlling tax-exempt organization receiving income in the form of rent, royalties, annuities or interest from a controlled subsidiary is subject to unrelated business taxable income on part or all of such income. The Pension Act provides that such payments from a subsidiary organization will be treated as unrelated business taxable income (UBTI) only to the extent that the payments exceed the amount of the specified payment that would have been paid or accrued if such payment had been determined under Code Section 482. In other words, the amount of any payment from the subsidiary to the parent that exceeds fair market value will be treated as unrelated business taxable income to the extent that such excess reduces the net unrelated income or increases the net unrelated loss of the controlled entity. In addition, the Pension Act imposes a penalty on the parent organization equal to 20 percent of the tax due on the excess payment. However, this amendment applies only to payments under written contracts that were in effect on the date of the Pension Bill's enactment and applies only to payments received or accrued between January 1, 2006 and December 31, 2007.

#### DISCLOSURE OF TRANSACTIONS WITH CONTROLLED ENTITIES AND TREASURY REPORT

The Pension Act requires that exempt organizations report the receipt of rent, interest, royalties, or annuities from controlled organizations, loans made to controlled organizations, and transfers of funds between it and controlled organizations, on Form 990. The Secretary of the Treasury is also directed to report to Congress by January 1, 2009 on the effectiveness of the fair market value standard for creation of unrelated business income under Section 512(b)(13).

#### ADDITIONAL SUPPORTING ORGANIZATION DISCLOSURE REQUIREMENTS

The Pension Act requires supporting organizations—those described in Sections 501(c)(3) and 509(a)(3)—to file a Form 990 regardless of the level of the organization's receipts. Further, supporting organizations must disclose on their Forms 990 the organizations they support as well as the type of supporting organization (Type I, II or III) the reporting organization is, as well as certify that the reporting organization is not controlled by disqualified persons.

#### NEW ACCURACY-RELATED PENALTIES FOR UNDERSTATEMENT OF TAX; NEW APPRAISAL REQUIREMENTS

The Pension Act lowers the threshold for imposing accuracy-related penalties related to valuation misstatements for income tax and gift and estate tax purposes. Under the new law, a taxpayer has *substantially* misstated a valuation for income tax purposes when the claimed value of any property is 150 percent or more of the amount determined to be the correct value, reduced from the current level of 200 percent. A *gross* valuation misstatement occurs when the claimed value is 200 percent or more of the amount determined to be the correct value. The minimum threshold for *substantial* valuation misstatement for gift and estate tax purposes is 65 percent or less of the amount determined to be at the correct value: this figure has been increased from 50 percent. A *gross* estate valuation misstatement exists when the claim value of the property is 40 percent or less of the amount determined to be the correct value. The new act also imposes new rules regarding appraisers and qualified appraisals.

#### DISCLOSURE OF PARTICIPATION IN INSURANCE TRANSACTIONS

The Pension Act creates new reporting rules for tax-exempt entities (including charitable organizations, governmental entities and Indian tribal governments) that acquire interests in life insurance, annuity or endowment contracts where the acquisition is part of a structured transaction involving a pool of such contracts. The new rules require that for transactions entered into after August 17, 2006 and on or before August 17, 2008, the tax-exempt organization must file an information return in a form and at such time as the Secretary of the Treasury prescribes. Certain transactions are exempt from the new reporting requirements, including (a) those in which all parties to the insurance contract other than the tax-exempt organization have independent insurable interests in the insured, (b) those in which the sole interest in the contract of the tax-exempt organization or of all parties other than the tax-exempt organization is as a named beneficiary, and (c) those in which the sole interest in the contract of each party other than the

tax-exempt organization is either as a beneficiary of a trust holding an interest in the contract (but only if the designation as beneficiary was made purely gratuitously) or as a trustee who holds an interest in the contract in a fiduciary capacity for the benefit of the tax-exempt organization or persons otherwise meeting one of the first two exemptions.

#### INCREASED PENALTIES FOR SPLIT-INTEREST TRUST'S FAILURE TO FILE TAX RETURN

The Pension Act doubles the per diem penalty for the failure of a split-interest trust to file its tax return, or Form 5227, from \$5 per day to \$10 per day. The maximum fine has increased from \$5,000 to of \$10,000. For split-interest trusts with gross income in excess of \$250,000, the penalty is \$100 per day, with a maximum penalty of \$50,000.

#### INCREASE IN INTERMEDIATE SANCTIONS MAXIMUM TAX FOR ORGANIZATION MANAGERS

Applicable to public charities and social welfare organizations, the intermediate sanction excise tax regime was intended to be a corollary to the private foundation self-dealing tax aimed at restricting transactions between public charities (and social welfare organizations) and disqualified persons to arm's length transactions involving fair market value consideration. However, unlike the self-dealing tax, intermediate sanctions do not strictly prohibit most transactions. The Pension Act increases the maximum tax on organization managers from \$10,000 in the aggregate per act to \$20,000 in the aggregate per act.

## Tougher Rules for Private Foundations

#### BROADENING OF 2 PERCENT EXCISE TAX ON NET INVESTMENT INCOME

The Pension Act expands the definition of "net investment income" for purposes of the private foundation excise tax on net investment income under Code Section 4940. The change will expand both the potential category of income producing assets that will be subject to the 2 percent excise tax and the types of capital gain property that, if sold, will result in capital gain that will be taxable as net investment income. For example, income from notional principal contracts, annuities and similar income from ordinary and routine investments are included in net investment income. Capital gains from appreciation, including capital gains and losses from the sale or other disposition of assets used to further an exempt purpose, are also included in net investment income.

#### INCREASE IN EXCISE TAXES FOR PRIVATE FOUNDATIONS

The Pension Act increases the tax rates of the punitive excise taxes first imposed on private foundations under the Tax Reform Act of 1969.

#### Self-Dealing

The self-dealing excise tax is designed to prohibit most transactions between a private foundation and any "disqualified person" as to that foundation (including substantial donors, trustees, directors, officers, their family members and entities and trusts controlled by or for the benefit of any of the foregoing). The Pension Act increases the self-dealing tax (at the initial level) from 5 percent to 10 percent of the "amount involved." Similarly, the initial self-dealing tax on foundation managers increases from 2.5 percent to 5 percent of the "amount involved," with the maximum tax increasing from \$10,000 in the aggregate per act to \$20,000 in the aggregate per act.

#### Undistributed Income

A private foundation is generally required to distribute its "income" each year, which is deemed to be roughly 5 percent of its investment assets. If a private foundation fails to annually distribute this amount, it will incur an excise tax on the undistributed amount. Under the Pension Act, the amount of this tax has increased from 15 percent to 30 percent of the undistributed amount.

#### Excess Business Holdings

Private foundations, when aggregated with their disqualified persons, generally are not permitted to own interests exceeding 20 percent in business enterprises. Interests above this permissible amount are referred to as "excess business holdings." Under the Pension Act, the initial tax on excess business holdings has increased from 5 percent of the value of the excess business holdings to 10 percent.

## Jeopardizing Investments

A private foundation is also prohibited from making investments that could jeopardize its charitable purposes. If a private foundation makes such a “jeopardizing investment,” the foundation managers responsible for the investment will incur a 10 percent excise tax, which is increased from 5 percent, with the dollar limitation on the initial tax imposed on foundation managers increasing from \$5,000 in aggregate per investment to \$10,000 per investment. The additional tax on foundation managers increases from \$10,000, to \$20,000.

## Taxable Expenditures

A private foundation is essentially limited to making distributions, or operating, for charitable purposes. If a foundation makes a distribution for non-charitable purposes, the distribution is called a “taxable expenditure” for which both the foundation and its managers will be liable for an excise tax. Under the Pension Act, the initial tax on taxable expenditures increases from 10 percent of the expenditure to 20 percent. The initial tax on foundation managers is increased from 2.5 percent to 5 percent, with the dollar limitations in the aggregate per taxable expenditure increasing from \$5,000 to \$10,000. The additional tax on foundation managers increases from \$10,000 to \$20,000 in the aggregate per taxable expenditure.

## EFFECTIVE PROHIBITION AGAINST PRIVATE FOUNDATION CONTRIBUTIONS TO CERTAIN SUPPORTING ORGANIZATIONS

The Pension Act precludes a private non-operating foundation from treating as a qualifying distribution any contribution to a Type III supporting organization (other than a “functionally integrated” Type III supporting organization defined below) or any other supporting organization, if a disqualified person of the private foundation controls (either directly or indirectly) either the supporting organization or the supported charity. Moreover, if a private foundation makes such a distribution, that distribution will be treated as a taxable expenditure for which the private foundation will be subject to an excise tax. This prohibition applies to distributions and expenditures made after August 17, 2006.

## Tougher Rules for Supporting Organizations

### NEW *PER SE* RULE FOR INTERMEDIATE SANCTIONS APPLICABLE TO SUPPORTING ORGANIZATIONS

The Pension Act imposes a *per se* intermediate sanctions rule for supporting organizations (whether Type I, II or III), similar to the self-dealing rules applicable to private foundations. Under the new rule, any grant, loan, payment of compensation or other similar payment to a substantial contributor, a relative of a substantial contributor, or a 35-percent owner of either, will be treated as an excess benefit transaction. The entire amount of the payment treated as the excess benefit will be subject to tax. This *per se* rules applies to transactions occurring after August 17, 2006.

### EXPANDED DEFINITION OF “DISQUALIFIED PERSON” FOR INTERMEDIATE SANCTIONS

The Pension Act expands the definition of “disqualified person.” Under the new definition a supporting organization’s disqualified persons for purposes of the intermediate sanctions provisions are also disqualified persons as to the supported charity.

### PROHIBITION AGAINST SUPPORT OF FOREIGN CHARITY

Under former law, Type III supporting organizations were often used by foreign charities as United States fundraising vehicles. These vehicles are often referred to as “American Friends” organizations. The Pension Act now prohibits a Type III supporting organization from supporting a foreign charity. For existing organizations, this provision will not become effective at the earliest on January 1, 2009.

### EXCESS BUSINESS HOLDINGS PROHIBITION APPLICABLE TO SUPPORTING ORGANIZATIONS

The Pension Act imposes on certain supporting organizations the prohibition on excess business holdings applicable to private foundations. This prohibition precludes an organization from owning more than 20 percent of a business enterprise when the organization’s holdings are aggregated with those of disqualified persons. For tax years beginning after August 17, 2006, Type III supporting organizations (other than functionally integrated organizations) will be subject to the prohibition against excess business holdings. In addition, a Type II supporting organization that has received a gift from any person who directly or indirectly controls the governing body of the supported charity, a family member of that person, or a 35-percent controlled entity

of that person or family member, will also be subject to the prohibition against excess business holdings. The Pension Act also includes transition rules by which a supporting organization has additional time (in some cases, up to 20 years) to dispose of its excess business holdings. In some instances, the Secretary of the Treasury may promulgate regulations excepting certain supporting organizations from the excess business holdings tax.

#### EFFECTIVE PROHIBITION AGAINST PRIVATE FOUNDATION CONTRIBUTIONS TO CERTAIN SUPPORTING ORGANIZATIONS

The Pension Act precludes a private non-operating foundation from treating as a qualifying distribution any contribution to a Type III supporting organization (other than a functionally integrated Type III supporting organization) or any other supporting organization, if a disqualified person of the private foundation controls (either directly or indirectly) either the supporting organization or the supported charity. Moreover, if a private foundation makes such a distribution, that distribution will be treated as a taxable expenditure for which the private foundation will be subject to an excise tax. This prohibition applies to distributions and expenditures made after August 17, 2006.

#### EFFECTIVE PROHIBITION AGAINST CONTROL OF SUPPORTING ORGANIZATIONS BY DONORS

The Pension Act provides that an organization is not a Type I or III supporting organization if it accepts any gift or contribution from a person who controls, directly or indirectly, with family members and 35-percent controlled entities, the governing body of a supported organization. A “person” for these purposes does not include a public charity described in Section 509(a)(1), 509(a)(2) or 509(a)(4) of the Code. This provision as written may have some implications for funds transfers within healthcare or other multicorporate systems headed by a Section 509(a)(3) parent.

#### SUPPORTING ORGANIZATION DISTRIBUTIONS

The Pension Act directs the Secretary of the Treasury to promulgate new regulations requiring any “Type III” supporting organization to annually distribute a percentage of either income or assets to that organization’s “supported charity.” A Type III supporting organization is a type of supporting organization that is “operated in connection with” one or more public charities, and historically has had a looser relation with its supported organization or organizations than other types of supporting organization. “Functionally integrated” Type III supporting organizations, which are supporting organizations that perform the functions of, or carry out the purpose of, one or more the supported charities, and will be exempt from these rules. Health care system “parent” organizations that are classified as Type III supporting organizations are usually “functionally related” and thus would not be subject to these payment rules.

#### STUDY ON SUPPORTING ORGANIZATIONS AND DONOR ADVISED FUNDS

The Pension Act directs the Secretary of the Treasury to conduct a study on the organization and operation of supporting organizations and donor-advised funds. The study is to review whether the deductions allowed for the income, gift or estate taxes for charitable contributions to sponsoring organizations of donor advised funds or to supporting organizations are appropriate in consideration of the use of contributed assets or the use of the assets of such organizations for the benefit of the person making the charitable contribution; whether donor advised funds should be required to distribute for charitable purposes a specified amount; whether the retention by donors to sponsoring organizations of rights or privileges with respect to amounts transferred to such organizations is consistent with the treatment of such transfers as completed gifts; and whether the above issues are also issues with respect to other forms of charities or charitable donations.

## New Rules Affecting Donor-Advised Funds

#### STUDY ON SUPPORTING ORGANIZATIONS AND DONOR ADVISED FUNDS (see section above)

#### NEW CODE SECTION 4966

The Pension Act includes two new Code sections dealing exclusively with so-called “donor-advised funds.” Under former law, donor-advised funds were not specifically defined under tax law, but rather were understood to be planned giving devices maintained by public charities. The Pension Act specifically defines donor-advised funds and subjects them and their “sponsoring

organizations” to a new regulatory regime. Under the new Code provisions, a donor-advised fund is generally a fund or account owned and controlled by a sponsoring organization that is separately identified by the contributions of one or more donors, and with respect to which a donor or his designee has advisory privileges over the distribution or investment of the fund or account. (A fund that makes distributions only to a single identified entity is not a donor-advised fund.) A sponsoring organization is a tax-exempt charitable organization, other than a private foundation, that maintains one or more donor-advised funds.

This new Code section contains a new punitive tax on certain distributions from donor-advised funds that are analogous to the taxable expenditure rules applicable to private foundations. Under this new law, a donor-advised fund is prohibited from making a distribution to any natural person or entity if the distribution is intended for a non-charitable purpose or the sponsoring organization for that donor-advised fund fails to exercise “expenditure responsibility” with respect to that distribution. “Expenditure responsibility” is an ongoing form of due diligence applicable to private foundations used as a means by which a donor foundation can ascertain that its grant to a donee organization is being used for the charitable purposes for which it was intended. A donor-advised fund can make grants to a public charity (other than certain supporting organizations), the fund’s sponsoring organization or another donor-advised fund without being subject to the expenditure responsibility requirement or this tax. Supporting organizations to which a donor-advised fund may not make distributions without imposition of the expenditure responsibility requirement or the tax are Type III supporting organizations that are not functionally integrated, as well as any other supporting organizations with respect to which any supported organization is controlled by the donor or a donor-designated advisor.

This tax is imposed on both the sponsoring organization of the donor-advised fund making the prohibited distribution, as well as the sponsoring organization’s officers, directors or employees responsible for the violation. The tax is 20 percent and 5 percent, respectively, of the amount distributed. These provisions apply for taxable years beginning after August 17, 2006.

#### NEW CODE SECTION 4967

The Pension Act also creates an entirely new excise tax applicable to persons related to donor-advised funds. This is aimed at preventing any donor-advised fund donor, donor advisor, family member of either, or 35-percent controlled entity of any of the above, from obtaining a non-incident benefit from a donor-advised fund. The tax on any such benefit is equal to 125 percent of the benefit’s amount. The tax may be imposed against the person who advised on the distribution and against the recipient of the benefit. The officer, director or employee of the sponsoring organization that agreed to the distribution knowing that it would confer a prohibited benefit will also be subject to a tax equal to 10 percent of the benefit, up to a total of \$10,000 in the aggregate per transaction. This tax will not be imposed if the “intermediate sanctions” tax on excess benefit transactions was imposed on the same transaction. The statute does not define the type of “benefit” that will subject the donor, donor advisor, family member or 35-percent controlled entity to tax. However, the legislative history indicates that there is a more than incidental benefit if a donor, donor advisor, or related person receives a benefit that would have reduced or eliminated a charitable contribution deduction if the benefit was received as part of a contribution to the sponsoring organization. These provisions apply for taxable years beginning after August 17, 2006.

#### DONOR-ADVISED FUNDS SUBJECT TO EXCESS BUSINESS HOLDINGS PROHIBITION

The Pension Act now subjects donor-advised funds to the excess business holdings excise tax that under former law applied only to private foundations. As with private foundations, donor-advised funds now are prohibited from owning significant holdings of more than 20 percent in a business enterprise. This figure is computed in combination with the holdings of “disqualified persons.” For purposes of this tax, “disqualified persons” include any donor, donor advisor, family member of either, or a 35-percent controlled entity of any of the above. Transitional rules apply to permit disposition of excess business holdings.

#### NEW *PER SE* RULE FOR INTERMEDIATE SANCTIONS APPLICABLE TO DONOR-ADVISED FUNDS

As with supporting organizations, the Pension Act imposes a *per se* intermediate sanctions rule for donor-advised funds, similar to the self-dealing rules applicable to private foundations. Under the new rule, any grant, loan, payment of compensation or other similar payment from a donor-advised fund to a donor, donor advisor, family member of either, or 35-percent controlled entity of any of the above, will be treated as an excess benefit transaction. The entire amount of the payment treated as the excess benefit will be subject to tax. Further, when such an excess benefit transaction is corrected, the repaid amount may not be held in any donor-advised fund. This *per se* rule applies to transactions occurring after August 17, 2006.

## EXPANDED DEFINITION OF "DISQUALIFIED PERSON"

For purposes of determining whether a transaction with a donor-advised fund is an excess benefit transaction based on whether the transaction is at fair market value, the Pension Act expands the definition of "disqualified person" to include a donor, donor advisor, family member of either, as well as an investment advisor to the sponsoring organization, an investment advisor's family member, and a 35-percent owned entity of any of the above.

## LIMITATION ON DEDUCTIBILITY OF CONTRIBUTIONS TO CERTAIN DONOR-ADVISED FUNDS

The Pension Act disallows an income tax deduction for any contribution to a donor-advised fund for which the sponsoring organization is a veteran's organization, fraternal society, or cemetery company, as those terms are described in Section 170(c)(3)-(5), or a Type III supporting organization (other than one that is functionally integrated). The Pension Act also includes similar provisions disallowing gift and estate tax deductions for such contributions. In addition, a donor to a donor-advised fund must obtain from the sponsoring organization a contemporaneous written acknowledgement that the sponsoring organization has exclusive legal control over the contribution if the donor wishes his or her contribution to be deductible.

## DISCLOSURE BY SPONSORING ORGANIZATIONS

Sponsoring organizations must disclose on their applications for exemption that they plan to operate donor-advised funds. Further, every sponsoring organization must disclose on its Form 990 the total number of donor-advised funds it owns, the aggregate amount of assets, and the contributions to and grants made from such funds.

## Principal Authors

**Neil T. Kawashima** is a partner in the law firm of McDermott Will & Emery LLP based in the Firm's Chicago office. As a member of the Private Client Department, Neil focuses his practice on the representation and advising of tax-exempt organizations, including private foundations and public charities. Neil also counsels individuals and families with respect to charitable giving techniques and philanthropy.

**Elizabeth M. Mills** is a partner in the law firm of McDermott Will & Emery LLP based in its Chicago office. She concentrates her practice on nonprofit organizations and their tax exemption concerns as well as health care organizations and hospital-physician transactions. Her practice with tax-exempt organizations includes addressing tax exemption compliance issues, such as intermediate sanctions and use of tax-exempt bond-financed property, representing organizations being audited by the IRS, and assisting organizations in obtaining tax exemption from the IRS.

IRS Circular 230 Disclosure: To comply with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained herein (including any attachments), unless specifically stated otherwise, is not intended or written to be used, and cannot be used, for the purposes of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter herein.

The material in this publication may not be reproduced, in whole or part without acknowledgement of its source and copyright. *Charity-Related Provisions of the Pension Protection Act of 2006: Significant New Rules and Restrictions* is intended to provide information of general interest in a summary manner and should not be construed as individual legal advice. Readers should consult with their McDermott Will & Emery lawyer or other professional counsel before acting on the information contained in this publication.

© 2006 McDermott Will & Emery. The following legal entities are collectively referred to as "McDermott Will & Emery," "McDermott" or "the Firm": McDermott Will & Emery LLP, McDermott Will & Emery/Stanbrook LLP, McDermott Will & Emery Rechtsanwälte Steuerberater LLP, MWE Steuerberatungsgesellschaft mbH, McDermott Will & Emery Studio Legale Associato and McDermott Will & Emery UK LLP. These entities coordinate their activities through service agreements. These entities coordinate their activities through service agreements. This communication may be considered advertising under the rules regulating the legal profession.

## Office Locations

### **Boston**

28 State Street  
Boston, MA 02109  
USA  
Tel: 617.535.4000  
Fax: 617.535.3800

### **Düsseldorf**

Stadttor 1  
40219 Düsseldorf  
Germany  
Tel: +49 211 30211 0  
Fax: +49 211 30211 555

### **Miami**

201 South Biscayne Blvd.  
Miami, FL 33131  
USA  
Tel: 305.358.3500  
Fax: 305.347.6500

### **Orange County**

18191 Von Karman Avenue, Suite 500  
Irvine, CA 92612  
USA  
Tel: 949.851.0633  
Fax: 949.851.9348

### **Silicon Valley**

3150 Porter Drive  
Palo Alto, CA 94304  
USA  
Tel: 650.813.5000  
Fax: 650.813.5100

### **Brussels**

Rue Père Eudore Devroye 245  
1150 Brussels  
Belgium  
Tel: +32 02 230 50 59  
Fax: +32 02 230 57 13

### **London**

7 Bishopsgate  
London EC2N 3AR  
United Kingdom  
Tel: +44 020 7577 6900  
Fax: +44 020 7577 6950

### **Munich**

Nymphenburger Str. 3  
80335 Munich  
Germany  
Tel: +49 89 12 7 12 0  
Fax: +49 89 12 7 12 111

### **Rome**

Via Parigi, 11  
00185 Rome  
Italy  
Tel: +39 06 4620241  
Fax: +39 0648906285

### **Washington, D.C.**

600 Thirteenth Street, N.W.  
Washington, D.C. 20005  
USA  
Tel: 202.756.8000  
Fax: 202.756.8087

### **Chicago**

227 West Monroe Street  
Chicago, IL 60606  
USA  
Tel: 312.372.2000  
Fax: 312.984.7700

### **Los Angeles**

2049 Century Park East, Suite 3400  
Los Angeles, CA 90067  
USA  
Tel: 310.277.4110  
Fax: 310.277.4730

### **New York**

340 Madison Avenue  
New York, NY 10173  
USA  
Tel: 212.547.5400  
Fax: 212.547.5444

### **San Diego**

4370 La Jolla Village Drive  
San Diego, CA 92122  
USA  
Tel: 858.535.9001  
Fax: 858.597.1585