Charitable Planning in 2007 and Beyond

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The Pension Protection Act of 2006 ("the Act") made a number of changes in the rules governing charitable organizations and charitable contributions, adding a few new incentives and even more new restrictions. These changes combine to make this already complicated area even worse. And Congress has a few more tricks up its sleeve. This presentation will review the recent and pending changes, and discuss how advisers should react.

I. The Pension Protection Act of 2006 – Summary of Charitable Provisions

A. Incentives (all expire 12/31/07)

- Charitable IRA Provision
- Conservation Incentives (50/100-%-of-AGI limitation, 15 year carryover)
- Extension of expanded deduction for contributions of "apparently wholesome food" inventory and book inventory
- Basis adjustment to stock of S. Corporation contributing property
- Increased penalty on split-interest trusts' failure to file returns or include required information [yes, Congress classified that as an "incentive"]

B. "Reforms" (i.e., new restrictions – all permanent)

- Reporting on acquisitions of interests in certain insurance contracts (including Treasury study on the use of insurance by tax-exempt organizations, due August 17, 2008)
- Doubling of initial taxes on all Chapter 42 private foundation taxes
- New rules for contributions of easements in registered historic districts
- New rules for "taxidermy contributions"
- Recapture of tax benefit when contribution of tangible personal property not used for an exempt use
- Limited deductions for contributions of clothing and household items
- Tougher rules for record keeping and substantiation of cash contributions

- New rules for contributions of fractional interests in tangible personal property
- Lower thresholds for accuracy-related penalties
- Tougher rules and penalties for appraisers
- Additional exemption standards for credit counseling organizations
- A broader reach for tax on net investment income of foundations
- New filing requirement for organizations excused from filing Form 990
- Facilitated disclosure of information by IRS to State officials
- Unrelated business income tax returns to be made public
- Treasury study of donor advised funds and supporting organizations (due August 17, 2007)
- New rules and restrictions for donor advised funds
- New rules and restrictions for supporting organizations

II. Practical Implications – A Checklist

It is evident from the list above that some of these changes are more important, or at least affect more planners and clients, than others. What follows is a summary of what steps may now be necessary for advisors to adapt to the new law. This should serve as a checklist for a number of areas in which the average planner is likely to encounter planning issues. Of course, some clients may be directly affected by the more obscure provisions, and to those clients, that is the most important provision in the Act. Here the focus will be what a mainstream planner needs to consider.

III. Charitable IRA.

The most avidly awaited new charitable incentive in the Act was a provision to facilitate tax-free distributions from individual retirement plans (IRA accounts) for charitable purposes. This had been discussed in planned giving circles for at least 15 years, and various versions of the plan had passed one or both houses of Congress several times, but never achieved in enactment.

Prior law permitted donors to make withdrawals from their IRA accounts to fund charitable transfers, but there was often a tax cost if this was done during the account-holder's lifetime. The receipt of such a distribution increased the recipient's income, and the subsequent contribution was deductible, but the percentage limitations often limited the amount the donor could deduct in the year the contribution was made, particularly for relatively large gifts. And the increased income resulting from the distribution could bring a tax cost as other deductions were indirectly disallowed.

The new rule follows the general approach of the earlier proposals, although it is much more limited than the earlier proposals. It provides that the person making a contribution from his or her IRA to charity will realize no income upon the removal of the funds from the IRA and will receive no deduction for the contribution of the funds to charity. New Code §408(d)(8) provides an exclusion from income for "qualified charitable distributions" from IRA accounts. This term refers to a distribution made directly by the IRA trustee to a charitable organization on or after the day that the individual for whom the plan is maintained reaches age 70½. This treatment is available only to the extent that the transfer to charity would otherwise be deductible; thus, any substantial benefit to the donor would render the amount in question taxable to the donor.

As noted above, the Charitable IRA provision in the Act has a number of limitations. It is limited in time, applying only to contributions made during 2006 and 2007, and amount ($100,000 per year). Moreover, unlike earlier proposals, it does not provide the same treatment for distributions from IRA accounts into charitable remainder trusts, pooled income funds, and charitable gift annuities. This final version applies only to direct charitable transfers.

Finally, not all charitable organizations qualify as recipients of qualified charitable distributions. The donee must qualify as a public charity described in §170(b)(1)(A), so private foundations are excluded (except for private operating foundations and other foundations that qualify for the 50-percent-of-AGI limitation). Supporting organizations and donor advised funds are specifically excluded.

> Note: Despite the exclusion of private foundations from the class of permissible donees of Charitable IRA contributions, some family foundations may nevertheless be able to benefit. For example, a donor who makes regular contributions to charity, may be able to use IRA funds for contributions to schools, churches, and other public charities, and contribute appreciated securities to his or her family foundation. Since the dollars involved are fungible, this approach may prove advantageous, allowing the donor to accomplish regular charitable objectives, while still utilizing the now-temporary charitable IRA provision, and bolstering the assets of the family foundation.

The Charitable IRA – Summary

- Only for donors who have already attained age 70 ½
- Limited to $100,000 per year.
- Unless extended by Congress, the charitable IRA provision expires at the end of 2007.
- Donee cannot be a private foundation, a donor advised fund, or a supporting organization.
- IRA distribution must be one that would otherwise be taxable
- Charitable contribution must be one that would otherwise be deductible
- Contributions must go directly from the IRA administrator to the donee charity. The check cannot be issued to the donor for transfer to the charity.
- Charitable distributions made under this rule will count toward the account holder's minimum distribution requirement.

- Unlike earlier Charitable IRA proposals, transfers to charitable remainder trusts and other split-interest arrangements are not permitted under the Act.
- Should be especially helpful for donors who use the standard deduction rather than itemizing their deductions, and for donors who live in states where the state income tax does not allow a charitable deduction.
- While the new rules apply only to lifetime contributions from IRA accounts, testamentary gifts to charity will still offer income and estate tax benefits, and will thus continue to be attractive for many donors.

IV. Conservation Incentives.

The Act created several new incentives to encourage contributions of capital gain real estate for conservation purposes. Instead of the usual 30%-of-AGI limitation, qualified conservation contributions made during 2007 will be subject to a 50%-of-AGI limit, with any excess carrying over for 15 years instead of the usual five. In the case of a qualified farmer or rancher, the percentage limitation is increased to 100% of AGI, also subject to a 15-year carryover. To be a qualified farmer or rancher, one must have more than 50% of his or her gross income for the taxable year from the trade or business of farming.

Conservation contributions by corporate farmers and ranchers get similar tax breaks. If the contribution is made by a corporation that is a qualified farmer or rancher, as described above and the stock of which is not publicly traded, and it is a contribution of property used in agriculture or livestock production, it is deductible to the extent it does not exceed the excess of the taxpayer's taxable income over the other contributions allowable for the year. Thus, such a taxpayer may completely eliminate its tax liability by means of such a gift. In this context, again, a 15-year carryover is provided in the gift exceeds the amount of the deduction allowable.

Only contributions made after 2005 and before January 1, 2008, will qualify for these conservation benefits described above.

Planning tip: Watch for possible extension of this incentive beyond 2007; The Senate Finance Committee approved such an extension in the "Heartland, Habitat, Harvest and Horticulture Act of 2007" (a/k/a "The 4-H Bill"). If a 2007 deduction under these rules is desired, remember conservation contributions can take longer to arrange than most other contributions – Start as soon as possible!

V. Other Incentives.

A. S Corporation Property Contributions – The Act provides a new rule benefiting charitable contributions of property made by S corporations. Under prior law, if an S corporation made a charitable contribution of appreciated property, each shareholder deducting his proportionate share of the gift was required to reduce the basis of his S corp. stock by his pro rata share of the *fair market value* of the contributed property. Under the new rule, such a shareholder will now reduce the basis of his S corp. stock by his share of the corporation's *basis* in the contributed property (rather than the FMV of the property). This benefits the shareholder by requiring a smaller basis reduction. This rule expires at the end of 2007.

B. Expiring Provisions Extended – Several expiring charitable provisions were extended by the Act. The provisions allowing expanded deductions for inventory contributions by certain taxpayers for contributions of "apparently wholesome food" inventory, and contributions of book inventory to public schools formerly expired at the end of 2005. The Act extends these provisions through the end of 2007.

VI. New Rules for Property Contributions

The Act imposes several new restrictions on various kinds of property contributions.

A. Taxidermy Property – At hearings in 2004, the Senate Finance Committee heard testimony describing an organization that purported to enable hunters to enjoy "tax deductible hunting" by contributing mounted animals to it and claiming inflated deductions based upon the costs of travel, etc. incurred in hunting the animals in question. That organization held the mounted animals for two years (to avoid the obligation to report their disposition to IRS) then sold them at auction for much less than the hunters' claimed deductions.

In an effort to prevent such abuses, the Act prescribes new rules for contributions of "taxidermy property" (defined for this purpose as any work of art that 1) is the reproduction of preservation of an animal in whole or in part, 2) is prepared, stuffed or mounted for purposes of re-creating one or more characteristics of such animal, and 3) contains a part of the body of the dead animal). When the contribution is made by the person who prepared or paid for the preparation of the property, the deduction is now limited to the lesser of basis or fair market value. In determining basis for this purpose, the only amounts taken into account are the costs of preparing stuffing or mounting; indirect costs such as costs, hunting, travel, etc. are not included.

These new rules apply to contributions made after July 25, 2006.

B. Recapture of Tax Benefit on Property Not Used for an Exempt Use – Since 1969, the Code has provided that a contribution of tangible personal property is reduced if the property is used by the donee in a manner unrelated to the donee's exempt purpose. In general, the amount of such a contribution is the taxpayer's basis in the property rather than the property's fair market value.

The Act adds a new rule recapturing the donor's tax benefit where tangible personal property is contributed and a deduction in excess of $5,000 is claimed at fair market value, but the donee somehow fails to put the property to a use related to its charitable purpose. If the donee disposes of the property within three years of its contribution, an amount equal to any excess of the deduction claimed over the donor's basis is added to the donor's income for the year in which the disposition occurs. The Joint Committee Explanation of the Act states that if the donee's disposition of the property occurs during the same year in which the contribution is made, the donor's deduction is reduced to basis and the disposition proceeds are an important indicator of fair market value.

The donor's tax benefit will not be adjusted under this rule if the donee organization makes a written certification to IRS under penalties of perjury, certifying that the donee's use of the property was related to its charitable function and describing how that occurred. A copy of this certification must be supplied to the donor (perhaps on the Form 8282), and a $10,000 penalty applies in the event of a fraudulent certification of exempt use property.

These rules apply to contributions made and returns filed after September 1, 2006. The $10,000 penalty applies to identifications made after the date of enactment (August 17, 2006).

C. Fractional Interests in Tangible Personal Property

A standard planning technique for contributions of valuable items of tangible personal property (such as artwork) is a fractional interest. For example, a donor might give a 20% interest in a valuable painting to a museum in order to limit the amount of deduction that must be claimed in the year of the gift. The Tax Court approved this concept, and allowed a deduction even when the donee failed to take possession of the property within the year, as required by the regulations, provided the donee had the right to claim the property for its fraction of the year. See *Winokur v. Commissioner*, 90 TC 733 (1988), acq. 1989-2 CB 1.

The Act continues to permit such deductions as under existing law, but provides for recapture of the donor's charitable deduction (for income tax and gift tax purposes) if, after making an initial fractional contribution, the donor or fails to contribute all of his or her remaining interest in the property to the same donee within 10 years (or before the donor's earlier death). If the original donee is no longer in existence, the donor may contribute be remaining interest to another charitable organization. If the donee fails to take substantial physical possession of the property during the period described, or fails to use the property born exempt use during that period, the donor's deductions under the income tax and the gift tax for all previous contributions will be recaptured (plus interest). Where such recapture occurs, an additional penalty tax equal to 10% of the amount of the recapture is also imposed.

Another new rule imposes a special valuation limitation on contributions of partial interests of tangible personal property. For income tax, gift tax and estate tax purposes, subsequent contributions of interests in the same property must be based on the lesser of the value at the time of the subsequent contribution or the value at the time of the initial contribution. Thus, if the property appreciates in value after the initial contribution, this increase will not benefit the donor's deductions for subsequent contributions. This valuation feature can make it hazardous to undertake a series of partial interest gifts.

> Example: Assume that a donor contributes a 10% interest in a painting worth \$10,000,000, claiming a \$1,000,000 income tax deduction. Five years later, when the painting is worth \$50,000,000, the donor dies, leaving the remaining 90% interest in the painting to the same donee. It is possible that, under this new rule, the donor's estate would include \$45,000,000 – 90% of the \$50,000,000 value – but her estate tax deduction for the bequest of that interest would be limited to 90% of the original \$10,000,000 value, or \$9,000,000. Thus, the donor's estate could be increased by \$36,000,000 as a result of her generosity, despite the absence of any tax abuse. While these facts are admittedly extreme, the result would be similarly unfavorable even if the amounts involved were smaller.

This provision takes effect for all contributions, bequests and gifts made after the date of enactment (August 17, 2006).

D. Conservation Easements – In addition to the new incentives described above, the Act also revises the rules for qualified conservation contributions relating to property located in a registered historic district. Easements protecting such property will continue to be deductible, but several additional requirements will apply.

- The portion of the easement relating to the exterior of the building must preserve the entire exterior of the building, including the space above the building, the side, the rear, and the front of the building.
- The easement must now provide that no portion of the exterior of the building may be changed in a manner inconsistent with the historical character of the exterior.
- Returns claiming such a deduction must include considerable new information, describing all current restrictions on development, etc., and the donor's deduction will be disallowed if this information is not provided.
- A taxpayer claiming a deduction in excess of \$10,000 for a conservation contribution involving the exterior of a building located in a registered historic district must pay a \$500 fee to IRS.

E. Clothing and Household Items – Valuation of contributions of used clothing and household items has been a sore point with IRS for some time. The Act addresses this problem by denying a deduction for such items, unless they are in "good used condition or better." IRS can provide by regulations that deductions will not be allowed for items having minimal monetary value, such as used socks and underwear.

Disallowance would not be required for contribution of an item of clothing or household item, valued at more than $500, provided the donor or includes with his or her return a qualified appraisal respect to the property. Certain items (food, paintings, antiques, art objects, jewelry and jams, and collections) are not subject to the new rules.

These rules are effective for contributions made after the date of enactment (August 17, 2006).

F. Appraisers and Valuations – The Act creates new qualification rules for appraisers and increases penalties for valuation misstatements.

- The threshold for imposing accuracy-related penalties for overstatement of the value of property contributions is lowered from 200% (of the true value) to 150%, the gross valuation misstatement threshold is lowered from 400% to 200%.
- Penalties on understatement of values for estate tax against tax purposes are similarly beefed up. In general, there is a substantial penalty if the valuation reported is 65% (formerly 50%) or less of the correct value, and a gross understatement is present, if the value is 40% (formerly 25%) or less.
- The accuracy-related penalties formerly did not apply if the taxpayer showed there was reasonable cause and he or she acted in good faith. The Act eliminates this exception.
- Appraisers are subject to increased oversight under the Act. A civil penalty of the greater of $1,000 or 10% of the understatement resulting from a valuation misstatement (up to a maximum of 125% of the gross income derived from the appraisal) applies to a person who prepares an appraisal that results in a valuation misstatement. The disciplinary rules for appraisers are also expanded. IRS no longer needs to apply a civil penalty before it can discipline appraisers by suspending or barring them from the parents in tax matters.

In addition, a new definition of qualified appraiser is provided. Under the Act, this is an individual who:

- Has earned an appraisal designation from a recognized professional appraiser organization or otherwise met minimum education and experience requirements, pursuant to forthcoming regulations;
- Regulate performs appraisals for compensation;
- Can demonstrate verifiable education and experience in valuing that type of property for which the appraisal is being performed;
- Has not been prohibited from practicing before the IRS at any time during the preceding three year period; and
- Is not excluded under applicable regulations.

Moreover, a qualified appraisal is redefined as an appraisal of property prepared by a qualified appraiser in accordance with generally accepted appraisal standards, including any regulations or other guides prescribed by IRS.

Most of these new appraiser and valuation rules apply to returns filed after the date of enactment (August 17, 2006).

G. Practical Implications -- Much of the potential difficulty faced in working on the new property contribution rules can be minimized, or even avoided, simply by keeping those rules in mind:

- Fractional Interests in Tangible Personal Property – While this has been a useful technique for many years, the changes in the Act make it unwise to undertake such a gift program today unless there is virtually no possibility that the property in question will appreciate in value (which is unlikely).
- New Focus on Exempt Use – A donee organization's use of contributed tangible personal property will now have to be monitored closely, not just at the time of contribution but for at least three years. Advisers must avoid the temptation to secure the donee's agreement to postpone sale or other transfer until the tattletale period (now three years) has run.
- Taxidermy Contributions – It Wasn't Broken, But Now It's Fixed – No competent advisor would have signed off on a client's participation in the transaction that gave rise to this unnecessary rule. Nevertheless, we now have a firm basis for advising such a client against participation.
- Clothing and Household Items – Although not usually a contribution on which an advisor's advice is sought, donors can avoid potential tax problems by being reasonable and realistic in valuing such property, and assuring that a zero deduction is taken on anything that is not in "good used condition or better" (whatever that means).

VII. Cash Contributions

Even a simple thing like a charitable contribution of money is made more complicated by the Act. Formerly, a canceled check, a receipt, or "other reliable written records" were sufficient, but under the Act," other written records" alternative is repealed. Thus, if a donor doesn't get a receipt, it will now be necessary to obtain a bank record substantiating a cash contribution.

VIII. Donor-Involved Philanthropy (Foundations and Foundation Alternatives)

Individuals considering the creation of a family foundation are urged to consider other alternatives, which might be more economical or efficient for some situations, particularly those involving smaller contributions. Two of those alternatives, donor advised funds and supporting organizations, are the subject of new regulatory schemes under the Act. The new restrictions are generally milder than those initially proposed, and are generally workable, but they will require some adjustments.

Study Underway – In addition to the actual changes described below, the Act directed the Treasury Department to conduct a study of these two types of organizations and report back to the Congress within a year. That study is to specifically consider the following items:

> Whether income tax, gift tax or estate tax charitable deductions are appropriate for these entities in view of (1) the use of the contributed assets including the type, extent and timing of such use, and (2) the use of the assets of the organization for the benefit of the person making the charitable contribution;
>
> Whether donor advised funds should be required to distribute a specified amount based on income or assets in order to ensure that the sponsoring organization is operating consistent with its exempt purposes and its status as a public charity;
>
> Whether the retention by donors of rights or privileges with respect to contributions to such organizations (including advisory rights or privileges with respective grants or investments) is consistent with pretty such contributions as completed transfers for deduction purposes; and
>
> Whether such issues also arise with respect to other forms of charities or charitable contributions.

That study could, of course, result in additional legislation affecting donor advised funds and supporting organizations. Planners should remain alert to the possibility of additional changes. Although the Act ordered that the Report be completed within a year (i.e., by August 17, 2007), it has not yet appeared and officials decline to say when it may emerge.

<u>Donor-Involved Philanthropy</u> – Three types of charitable organizations are classified under the heading of "donor-involved philanthropy" because they afford donors a greater degree of personal involvement in the use of their contributions after the initial transfer. These are the private foundation, the supporting organization, and the donor advised fund.

Historically, since 1969, charitable organizations have been divided into only two categories – <u>private foundations</u>, which were subject to a particularly rigorous set of restrictions, and <u>public charities</u>, which were not. A donor who found the private foundation restrictions too onerous good often avoid them by resorting to supporting organization or a donor advised fund, since both of the latter two were classified in the favored public charity category. The Pension Protection Act blurred this distinction, leaving no clear advantage to any single category.

In a discussion which follows, we will review the new rules affecting each of these organizations, with quite a bit of unavoidable overlap.

SUPPORTING ORGANIZATIONS

A. General – Supporting organizations have often been used when a person who might otherwise choose to create a private foundation finds that some aspect of the private foundation rules makes that impractical. A supporting organization may resemble a private foundation in many respects, but because of its relationship with one or more public charities, which serve as its beneficiaries, it treated itself as a public charity rather than a private foundation. [In the discussion that follows, those public charities are referred to as the supported organizations.]

There are three separate types of supporting organizations. They are generally referred to by number as "Type 1," "Type 2," or "Type 3." Type 1 and Type 2 supporting organizations have a particularly close relationship with their supported organizations. However, the type 3 organization is merely "operated in connection with" its supported organizations, which gives more leeway for independence (a/k/a planning potential).

It is the Type 3 supporting organization that is most often proposed as an alternative to a family foundation, precisely because it does offer this leeway. As is so often the case, however, that leeway often led to abuses, and it is those abuses that the Act sought to stop. The Act imposed a number of new requirements for supporting organizations, aimed primarily, but not exclusively, at Type 3 supporting organizations.

One of the key concepts in the new type 3 supporting organization rules is that of a "functionally integrated" organization. Although this term is central to several of the new provisions, this concept remains a bit unclear. In general, a functionally integrated organization is one which, rather than simply providing funds to its supported organization, conducts activities that relate to the performance of the supported organizations functions or carrying out its purposes. For example, a blood bank operated by hospital would presumably be considered as functionally integrated with its parent organization. In many cases, however, the presence or absence of this relationship may not be entirely clear, so regulations or perhaps even a clarifying amendment may be necessary to enable planners to work with and apply this provision.

B. Automatic Excess Benefit Transactions – Since they are not private foundations, by definition, supporting organizations have been subject to the intermediate sanctions rules, which provide penalty excise taxes on so-called "excess benefit transactions" under Code §4958. The Act greatly expands the application of those penalty taxes to supporting organizations.

Under the new rules, if any supporting organization, Type 1, Type 2, or Type 3, makes a grant, loan, compensation payment, or other similar payment to a substantial contributor of the supporting organization (or a related person), the payment is automatically treated as an excess benefit transaction with a disqualified person. Moreover, the entire amount of the payment is treated as the taxable excess benefit. The same is true of a loan by any supporting organization to a disqualified person (applying the existing definition in Code §4958).

Note also that, under the Act, for purposes of the excess benefit transaction rules in Code §4958, a person who is a disqualified person all the supporting organization will also be treated as a disqualified person of the supported organization.

These rules are stricter than the general rule applicable to other public charities, where the excess benefit is only the amount by which the benefit provided exceeds the value of the consideration received.

C. <u>Excess Business Holdings</u> – Formerly, supporting organizations were sometimes used as a means of holding family business interests in situations where Code §4943 would prevent a family foundation from doing so. To prevent this, the Act made the excess business holdings rules of Code §4943 applicable to type 3 supporting organizations (<u>except</u>) those which are functionally integrated.

The excess business holdings rules also now apply to Type 2 supporting organizations if they accept a contribution from a person (other than a public charity) having direct or indirect control of its supported organization. And if a Type 1 or Type 3 supporting organization accepts a gift from such a person, it is treated as a private foundation for all purposes, until it demonstrates to the satisfaction of IRS that qualifies as a public charity, other than as a supporting organization.

D. <u>Distributions to Supporting Organizations</u> – In general, private foundations may not count distributions to Type 3 supporting organizations as qualifying distributions for purposes of the minimum distribution requirement imposed on foundations under Code §4942. This rule does not apply if the recipient is a functionally integrated Type 3 supporting organization.

E. <u>Practical Implications</u> – The foregoing rules do not provide any complete listing of the changes were supporting organizations under the Act, but they are probably the rules most likely to be encountered by the typical planner. Obviously, the result is an entirely different climate for supporting organizations in the Post-Act climate. The following are among the practical issues planners must now be prepared to face:

1. <u>Existing Supporting Organizations May Need Attention</u>

Clients for whom you set up a supporting organization several years ago are now playing in a game which the rules are changed, and they may be unaware of the changes. Consider the following situations:

- The supporting organization set up to hold business interests, perhaps as an important part of the client's estate plan
- The supporting organization for which the founder's family members serve as paid employees

- The supporting organization that has loans outstanding to any disqualified persons (including related business interests)
- The supporting organization whose Board of Directors is calculated to give the donor(s) a measure of influence that approaches actual control
- The supporting organization structured as a Type 3 SO supporting a large number of public charities, making it a non--functionally integrated supporting organization under the new rules.

2. Some Supporting Organization Clients May Want Out

Clients in the situations described above, and others, may now find that they do not want to continue in a supporting organization format. The following alternatives are available to rectify this situation:

- Devise a public fundraising plan and achieve sufficient public support to make the organization a publicly supported charity under §170(b)(1)(A)(vi) – [not easy]
- Terminate by transferring all assets to a donor advised fund or other public charity
- Terminate by distributing all assets and going out of business
- Become a private foundation. Note that, in PLR 9852023, the IRS held that, for purposes of the excise tax on private foundation income under §4940, the "new" foundation took a new basis in its assets equal to the value of such assets on the date of conversion.

Caution: Consider whether local law, the Attorney General, or the IRS may object if the organization seeks to abandon its former supported organizations - see PLR 9052055 involving a supporting organization operated for the benefit of a university. When one of the trustees died, his widow, who was also a trustee, decided to broaden the purposes of the supporting organization so that it could also serve her other charitable interests in addition to the university. Accordingly, it was proposed to amend the organization's articles of incorporation and bylaws to delete all references to the university as a supported organization, thereby converting it to a private foundation. The university representatives on the board would resign and be replaced by family representatives. Once that had occurred, the organization (which then became a private foundation) would transfer to the University stock with a value estimated at approximately one-half of its assets.

On these facts, IRS ruled that the organization's classification as a supporting organization would terminate and it would become a private foundation; it would be required to file two separate returns for the year of the conversion -- Form 990 for the period up to the conversion date, and Form 990-PF for the period from the conversion date to the end of its taxable year. The ruling also held that the transfer to the university after the conversion would be a qualifying distribution for purposes of the foundation's minimum distribution requirement under IRC §4942.

3. New Rules for Type 3 Supporting Organizations -- A Work in Progress

The Act directed the Treasury Department to promulgate new regulations to impose a minimum payout requirement on Type 3 supporting organizations that are not functionally integrated with their supported public charities. On August 2, 2007, IRS issued an advance notice of proposed rulemaking describing regulations that the treasury and IRS anticipate proposed. Among those proposals are:

- A 5% (of assets) payout for non--functionally integrated Type 3 supporting organizations, in place of the 85%-of-income standard in the existing regulations
- A new rule would limit the number of supported organizations not more than five friends but existing organizations continue to support more than five if they contribute at least 85% of the new required payout amount to, or for the use of, existing supported organizations
- Quantitative tests, drawn from the existing private operating foundation concepts, for functionally integrated Type III supporting organizations

4. Planning for the New Supporting Organization

Obviously, planners will have to reconsider the utility of a supporting organization for many client situations, such as the business interests, family employees, etc. situations described above.

5. More Rules on the Way!

As pointed out above at page 9, the Act directed IRS and the Treasury Department to conduct a study of supporting organizations and donor advised funds, with a report back to Congress due August 17, 2007. Although they have already missed that deadline, the study is underway and is quite likely to result in additional legislation affecting donor advised funds and supporting organizations.

6. Is the Supporting Organization Still a Viable Alternative to the Family Foundation?

Historically (since 1969) there have been only two types of organizations – public charities and private foundations. There were strict rules for private foundations, and these did not apply to public charities. Supporting organizations were public charities that resembled private foundations is that they contemplated some donor involvement in their charitable programs, but the private foundation restrictions did not apply. This made the supporting organization an attractive alternative in many situations.

The Act changed those dynamics and singled out the supporting organization (and the donor advised fund, discussed below) for treatment that is in some respects less favorable than either the public charity or the private foundation. As a result, the planner must re-examine traditional attitudes and planning approaches in selecting charitable vehicle for a client.

DONOR ADVISED FUNDS

A. New Regulatory Structure

In recent years, donor advised funds have proliferated, becoming a very popular alternative for a person considering a private foundation. Neither the Internal Revenue Code nor the Regulations, however, have heretofore provided any specific rules governing donor advised funds. As with any situation in which the rules are unstated or unclear, this absence of specific rules lead to abuse by some organizations. The vast majority of American donor advised funds, including those operated by community foundations or by mutual funds or other financial institutions, were not involved in such abuses and will be only minimally affected by the changes.

To set the stage, a donor advised fund is normally a program offered by a public charity to facilitate charitable gifts by individual donors. In the discussion that follows, that public charity is referred to as the "sponsoring organization." It may be a community foundation or other public charity with an independent charitable program of its own, or it may have no program aside from the donor advised fund operation.

The Act starts out by creating a statutory definition for donor advised funds, then proceeds to impose a number of special rules on the organizations falling within that definition.

B. Taxable distributions

Certain types of distributions are in effect forbidden, and will be subject to a new penalty excise tax under new Code §4966. These "taxable distributions" include any distributions paid to a natural person, or to any other person for a noncharitable purpose. Even if the distribution is made for a charitable purpose, the tax will apply if the sponsoring organization does not exercise expenditure responsibility in accordance with Code §4945(h).

A distribution to a public charity or to the sponsoring organization of the fund, or to another donor organized fund, will not normally be a taxable distribution, except in the case of a distribution to a" disqualified supporting organization." Disqualified supporting organizations include any Type 3 supporting organization other than one that is "functionally integrated" (as discussed below), or any other supporting organization if the donor or a donor advisor of the donor advised fund has direct or indirect control; IRS is authorized to determine by regulation that other distributions to supporting organizations are inappropriate.

It should be noted that these rules are less restrictive that the comparable rules in the initial version of this legislation passed by the Senate last year. For example, that earlier proposal would have prevented a distribution from one donor advised fund to another, thus preventing a donor from requesting a transfer of his fund account to another sponsoring organization.

C. More Than Incidental Benefit

If a donor advised fund distribution results in a more-than-incidental benefit to a donor or a donor advisor, or any related person who provided advice regarding the distribution, the Act imposes an excise tax equal to 125% of the amount of the benefit against both the person who advised the distribution and the recipient of the benefit. This is provided in new Code §4967. If a manager of the sponsoring organization agreed to the making of the distribution knowing that it would confer such a benefit, the manager is equal to a 10% excise tax (not to exceed $10,000). These taxes are subject to abatement under the general rules of existing law.

The existence of a more than incidental benefit is determined under the same rules as are used to determine when the receipt of the benefit would reduce or eliminate a charitable deduction. For example, if it down or advises a distribution from is done or advised fund to the Girl Scouts of America, the mere fact that the donor or his daughter is a member of the local Girl Scout unit would not be sufficient to incur the new excise tax. Such a benefit would be incidental.

D. Automatic Excess Benefit Transactions

The Act effectively prevents any grant, loan, compensation, expense reimbursement or other similar payment from a donor advised fund to a donor, donor advisor, or related persons. Any such payment is now automatically treated as an excess benefit transaction under the intermediate sanctions rules, Code §4958. Regardless of the facts, the tax is imposed upon the full amount paid, and not just any excessive portion.

Amounts paid under a bona fide sale or lease of property are not subject to this special rule, but are instead subject to the general arm's-length rules of Code §4958, with the special disqualified person definition described below applicable. The technical explanation of the Act makes it clear that a substance-over-form analysis will apply to determine whether a purchase is made from a donor advised fund (in which case the full amount involved will be deemed the excess benefit) or from the sponsoring organization (in which case an arm's-length standard will apply).

For example, consider the situation where a donor contributes securities to a donor advised fund, the donor advised fund then distributes them to the sponsoring organization, and the donor purchases the securities from the sponsoring organization. Under such circumstances, the distribution to the sponsoring organization will be ignored, so that the purchase from the sponsoring organization is subject to tax under Code §4958.

A person who is a donor to a donor advised fund will not be treated as a disqualified person with respect to the sponsoring organization by virtue of that fact alone. Thus, if the donor to a donor advised fund is a service provider to the sponsoring organization, the general rules of Code §4958 (applying an arm's length standard) will generally apply to the payment received for such services. Similarly, an investment adviser (and related persons) is treated as a disqualified person with respect to the sponsoring organization.

E. Excess Business Holdings

The private foundation rules governing excess business holdings (Code §4943) will apply to donor advised funds. In applying those rules, the term "disqualified person" will include donors, donor advisors, members of the family of either, and 35% controlled entities of any such person.

Transition rules similar to those in Code §4943(c)(4)-(6) are to be applied to the present holdings of the donor advised fund, presumably via Regulations. The exact meaning of this is not entirely clear, but it appears that a fund will generally have ten to twenty years to dispose of interests held as of August 17, 2006, and five years to dispose of gifts and bequests acquired thereafter. The transition rules of §4943 are extremely complicated, and their application to donor advised funds will not be easy to understand and apply.

F. Deductions for Contributions to Donor Advised Funds.

No deductions are allowed for contributions to donor advised funds unless the sponsoring organization is a qualified charitable organization described in Code §170(c), other than a private foundation. Thus, contributions to donor advised funds operated by other types of exempt organizations no longer qualify for charitable deductions for income tax, gift tax, or estate tax purposes. If the sponsoring organization is a Type 3 supporting organization, deductions for contributions will be denied unless the sponsor is a functionally integrated Type 3 supporting organization, as discussed above.

Additional substantiation requirements, beyond those applicable to charitable contributions generally under Code §170(f), apply for contributions to donor advised funds at. The contemporaneous written acknowledgment (i.e., receipt) provided by the sponsoring organization must state specifically that the sponsoring organization has exclusive legal control over the assets contributed.

G. Practical Implications

Most responsible donor advised funds operate in basically the matter dictated by the new rules. Thus, donors to traditional community foundations and funds operated by financial firms (e.g., the Fidelity Charitable Gift Fund and similar entities) typically are not given an opportunity to receive grants, loans, or compensation, or to contribute business interests or other problematic assets.

Despite this, there are several still several important points for the planner to consider, including the following:

- Private Benefit -- Don't Even Think of It! – Private benefit rules can have some unexpected effects. For example, some community foundations allow donors to bifurcate some contributions, such as the cost of tickets to a fund-raising dinner or other event. In such instances, the donor may advise a grant from his/her donor advised fund account to pay the portion of the ticket cost that would be deductible if paid directly, but write a personal check for the value of the non-deductible part. Unless and until IRS clarifies this, such a practice should be approached with caution.
- Donors -- Check Your Receipts – As noted above, the receipt for a contribution to a donor advised fund is now required to include language warning that that the sponsoring organization has exclusive legal control over the assets contributed.
- More Rules on the Way! -- As pointed out above in connection with supporting organizations, the Act directed the Treasury Department to conduct a study of donor advised funds, reporting back to Congress within a year. When that report is released, it could result in additional restrictions on donor advised funds and their contributors.
- Donor Advised Fund vs. Family Foundation – Just as the new rules imposed under the Act affect the viability of supporting organizations as alternatives to clients considering a private foundation, the new donor advised funds may have some impact. However, as pointed out above, the typical donor is not as intimately involved with the operations of the donor advised fund, and is thus not as likely to encounter disappointment under the new rules. In fact, many clients who formerly chose a supporting organization may wish to terminate that and distribute the remaining assets into a donor advised fund account.

PRIVATE FOUNDATIONS: LOOKING BETTER

As described above, private foundations were formerly the most disadvantaged category of charity, with more restrictive operating rules and limitations on donors' deductions than any category of public charity. The Act changes this balance, and some donors may find that private foundation status is preferable to continued existence as a supporting organization, while others may find it a donor advised fund brings restrictions they'd rather avoid.

The principal change in the rules governing private foundations is a simple doubling of all of the initial taxes imposed under the Chapter 42 penalty provisions, plus a doubling of the maximum exposure of foundation managers for several the taxes. See Table 1, below, for details.

TABLE 1 – Chapter 42 Initial Tax Rates

	Former Law	New Law
Self-dealing (§4941)		
Initial tax on self dealer	5%	10%
Initial tax on foundation manager	2½ %	5%
Failure to distribute income (§4942)		
Initial tax	15%	30%
Excess business holdings (§4943)		
Initial tax	5%	10%
Limits on foundation managers (per investment)		
Initial tax	$5,000	$10,000
Additional tax	$10,000	$20,000
Jeopardy investments (§4944)		
Initial tax	5%	10%
Taxable expenditures (§4945)		
Initial tax on foundation	10%	20%.
Initial tax on foundation managers	2½ %	5%
Limits on foundation managers		
Initial tax	$5,000	$10,000
Additional tax	$10,000	20,000

Of course, foundations didn't get through the Act scot-free, but most of the changes won't have any effect upon the average family foundation:

- Doubled Penalties – This shouldn't be a problem, since the name of the game has always been to avoid those penalties. Nevertheless, it should be noted that this "quick-and-dirty" fix compromises one of the basic principles of the Tax Reform Act of 1969, which introduced the private foundation penalty excise taxes. The stated intention of the 1969 Act was to subject foundation misdeeds to a two-tier tax system, with violations subject first to a mild penalty, with a tougher penalty to follow if the violation wasn't corrected. As the following table indicates, the initial taxes can now run as high as 30% -- hardly a mild penalty.

- Watch out for Grants to Supporting Organizations – Under the pre-Act system, grants to public charities were always qualifying distributions for purposes of the minimum distribution requirement of §4942. Now, however, foundations must make further inquiries in the case of one category of public charity -- supporting organizations. It will first be necessary for a foundation to determine whether a prospective supporting organization grantee is a Type 1, Type 2, or Type 3 SO. From there on, the rules get somewhat complicated.

- *Type I, II, and functionally integrated Type III supporting organizations*. Private foundations may make distributions to Type I, Type II, or functionally integrated Type III supporting organizations; these distributions will count as part of the foundation's qualifying distribution amount for the year. However, if a disqualified person to the foundation controls the Type I, Type II, or functionally integrated Type III supporting organization, or if that disqualified person controls a supported organization of that supporting organization, the foundation must exercise expenditure responsibility.
- *Type III non-functionally integrated supporting organizations*. Private foundations may also make distributions to Type III supporting organizations that are not functionally integrated so long as they exercise expenditure responsibility. However, these distributions will not be considered qualifying distributions for purposes of the foundation's annual required distribution amount, and will be considered a taxable expenditure if the foundation does not engage in expenditure responsibility.

- PF or DAF or SO? -- The New Algebra – As discussed above, the Act alters the balance between these three categories of exempt organization. Determination of which format is preferable for a given client will require careful examination of the facts.

IX. Working with the New Rules

The new rules for property contributions under the Act place in increased premium on getting the value right, or at least avoiding excess valuations. In addition to the various specific penalties, the standard overvaluation penalties have been toughened, and appraisers are subject to stiffer rules. As a result, advisers must be prepared to restrain the donor who contemplates entering into a contribution situation under conditions which the donor believes he or she will achieve some sort of "edge" that produces a higher deduction.

Remember that the incentive provisions of the Act all expire on December 31, 2007. Thus, clients who may be interested in making charitable contributions from their IRA account, or taking advantage of the liberalize rules for contributions of conservation easements may need a gentle reminder. Particularly in the case of the easement transactions, the negotiation and drafting aspects of the contribution can be quite time consuming. These incentives may be extended, but then again they may not, and even if they are extended that may not happen until months after the expiration date.

X. What's Next?

The provisions described above are not the final word from Congress on new requirements for charitable organizations and contributions. The Act commissioned several studies by IRS, with public input, designed to assist in determining whether additional legislation is necessary. One of these studies deals with the question of whether additional requirements should be imposed upon donor advised funds and supporting organizations. Another addresses the issues posed by transactions wherein charities and other exempt organizations acquire life insurance contracts and private investors also have an interest in such contracts.

Also, both the Senate Finance Committee and the House Ways and Means Committee have announced ongoing studies of charitable organizations designed to determine what if any additional legislation is needed. The Senate Finance Committee has issued a discussion draft focusing primarily on nonprofit hospital issues, and the Committee still has a number of outstanding issues, particularly in the governance area, from its 2004 discussion draft addressing general charitable proposals. The House Ways and Means Committee has indicated it its interest in examining broad questions about the role of charity and the effectiveness of the charitable sector in fulfilling its intended function.

A technical corrections bill has been introduced to correct various flaws in the Pension Protection Act of 2006, but that bill to address any significant corrections or changes in the charitable provisions of the Act.

XI. Beyond the Pension Protection Act

When a significant new law is adopted, it tends to dominate the attention of planners trying to keep up to date in the field in question. This is certainly been the case with the charitable provisions of the Pension Protection Act of 2006, but of equal importance are some other developments and potential developments.

A. More Legislation? – We have already seen that the Act ordered several IRS studies that are likely to lead to additional legislative activity. The first of these deals with several very broad involving supporting organizations and donor advised funds, and another deals with dissipation of exempt organizations in various types of insurance transactions. Equally important, however, are several other topics that are receiving Congressional attention:

- Expansion and extension of the Charitable IRA provision
- Moderation of some of the more extreme provisions in the Act, particularly those dealing with partial interest gifts of artworks and some of the rules for supporting organizations
- Basic tax reform (Chairman Rangel of the House Ways and Means Committee has indicated his committee will consider “the mother of all tax reform later this year)

- Modification/elimination of the alternative minimum tax
- Estate tax reform
- Governance and transparency for exempt organizations
- Other legislation prompted by reports of scandal, excess of compensation, and other abuses in the nonprofit world

B. Don't Forget the IRS! – It is important not to focus so much attention on legislative developments and prospective legislative developments that ongoing releases from the Internal Revenue Service are overlooked.

- Watch for proposed regulations on various topics addressed in the Pension Protection Act.
- Sample charitable lead trust forms are now available; see **Revenue Procedure 2007-45; 2007-29 IRB 1**, providing forms for the inter vivos charitable lead annuity trust, and **Revenue Procedure 2007-46, 2007-29 IRB 1,** dealing with the testamentary charitable lead annuity trust. In the case of the inter vivos trust, Revenue Procedure 2007-45 gives advisors two full sets of sample trust, annotations and alternative clauses – one set for the nongrantor CLT plus another set for the grantor CLT.
- Charitable lead unitrust sample forms are still in process.
- Increased audits of nonprofits promised.

C. It's Not Just Taxes! – Inevitably, discussions of charitable planning tend to focus primarily on tax issues. Planners must remain aware of the fact that there are other considerations to be taken into account. Several recent developments provide grim reminders:

- The State of Maine Office of Securities last year proposed to revoke the securities license of a registered representative there who it found had invested charitable funds of which he was trustee in a variable annuity contract (which it characterized as "an unsuitable investment"), and thereby incurred excessive fees and commissions. The administrative "Notice of Intent" is available online at – http://www.maine.gov/tools/whatsnew/index.php?topic=SEC-LegalDocs&id=33093&v=Default .
- Remember, the T in CRT stands for "Trust." When a CRT is planned on the basis of financial advantages, the client may not realize that the legal relationship created is a trust. An amateur trustee (e.g., the client serving as "his own" trustee may be unaware of (1) the fiduciary duties owed to ALL beneficiaries, and (2) the fact that the attorney general may be interested in the trustee's decisions.
- In *Smallegan v. Kooistra*, 2007 WL 840123 (Mich. Ct. App. Mar. 20, 2007), a Michigan appeals court found that a lawyer was not liable for disappointment of the son of a client for whom he and his firm had prepared a charitable remainder trust, where plans to purchase "wealth replacement insurance" could not be a conflict because the client was

uninsurable. [Note: The lawyer successfully defended the claims against him, BUT IS THAT A WIN?]