

**TECHNICAL EXPLANATION OF H.R. 4,  
THE “PENSION PROTECTION ACT OF 2006,”  
AS PASSED BY THE HOUSE ON JULY 28, 2006,  
AND AS CONSIDERED BY THE SENATE  
ON AUGUST 3, 2006**

Prepared by the Staff  
of the  
JOINT COMMITTEE ON TAXATION



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## INTRODUCTION

This document,<sup>1</sup> prepared by the staff of the Joint Committee on Taxation, provides a technical explanation of the “Pension Protection Act of 2006,” as passed by the House of Representatives on July 28, 2006, and as considered by the Senate on August 3, 2006.

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<sup>1</sup> This document may be cited as follows: Joint Committee on Taxation, *Technical Explanation of H.R. 4, the “Pension Protection Act of 2006,” as Passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006* (JCX-38-06), August 3, 2006.

## TITLE XII: PROVISIONS RELATING TO EXEMPT ORGANIZATIONS

### A. Charitable Giving Incentives

#### 1. Tax-free distributions from individual retirement plans for charitable purposes (secs. 408, 6034, 6104, and 6652 of the Code)

##### Present Law

##### In general

If an amount withdrawn from a traditional individual retirement arrangement (“IRA”) or a Roth IRA is donated to a charitable organization, the rules relating to the tax treatment of withdrawals from IRAs apply to the amount withdrawn and the charitable contribution is subject to the normally applicable limitations on deductibility of such contributions.

##### Charitable contributions

In computing taxable income, an individual taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and up to the fair market value of property contributed to a charity described in section 501(c)(3), to certain veterans’ organizations, fraternal societies, and cemetery companies,<sup>284</sup> or to a Federal, State, or local governmental entity for exclusively public purposes.<sup>285</sup> The deduction also is allowed for purposes of calculating alternative minimum taxable income.

The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.<sup>286</sup>

A taxpayer who takes the standard deduction (i.e., who does not itemize deductions) may not take a separate deduction for charitable contributions.<sup>287</sup>

A payment to a charity (regardless of whether it is termed a “contribution”) in exchange for which the donor receives an economic benefit is not deductible, except to the extent that the donor can demonstrate, among other things, that the payment exceeds the fair market value of the benefit received from the charity. To facilitate distinguishing charitable contributions from purchases of goods or services from charities, present law provides that no charitable contribution deduction is allowed for a separate contribution of \$250 or more unless the donor obtains a contemporaneous written acknowledgement of the contribution from the charity

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<sup>284</sup> Secs. 170(c)(3)-(5).

<sup>285</sup> Sec. 170(c)(1).

<sup>286</sup> Secs. 170(b) and (e).

<sup>287</sup> Sec. 170(a).

indicating whether the charity provided any good or service (and an estimate of the value of any such good or service) to the taxpayer in consideration for the contribution.<sup>288</sup> In addition, present law requires that any charity that receives a contribution exceeding \$75 made partly as a gift and partly as consideration for goods or services furnished by the charity (a “quid pro quo” contribution) is required to inform the contributor in writing of an estimate of the value of the goods or services furnished by the charity and that only the portion exceeding the value of the goods or services may be deductible as a charitable contribution.<sup>289</sup>

Under present law, total deductible contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer’s contribution base, which is the taxpayer’s adjusted gross income for a taxable year (disregarding any net operating loss carryback). To the extent a taxpayer has not exceeded the 50-percent limitation, (1) contributions of capital gain property to public charities generally may be deducted up to 30 percent of the taxpayer’s contribution base, (2) contributions of cash to private foundations and certain other charitable organizations generally may be deducted up to 30 percent of the taxpayer’s contribution base, and (3) contributions of capital gain property to private foundations and certain other charitable organizations generally may be deducted up to 20 percent of the taxpayer’s contribution base.

Contributions by individuals in excess of the 50-percent, 30-percent, and 20-percent limits may be carried over and deducted over the next five taxable years, subject to the relevant percentage limitations on the deduction in each of those years.

In addition to the percentage limitations imposed specifically on charitable contributions, present law imposes a reduction on most itemized deductions, including charitable contribution deductions, for taxpayers with adjusted gross income in excess of a threshold amount, which is indexed annually for inflation. The threshold amount for 2006 is \$150,500 (\$75,250 for married individuals filing separate returns). For those deductions that are subject to the limit, the total amount of itemized deductions is reduced by three percent of adjusted gross income over the threshold amount, but not by more than 80 percent of itemized deductions subject to the limit. Beginning in 2006, the overall limitation on itemized deductions phases-out for all taxpayers. The overall limitation on itemized deductions is reduced by one-third in taxable years beginning in 2006 and 2007, and by two-thirds in taxable years beginning in 2008 and 2009. The overall limitation on itemized deductions is eliminated for taxable years beginning after December 31, 2009; however, this elimination of the limitation sunsets on December 31, 2010.

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity (e.g., a remainder) while also either retaining an interest in that property (e.g., an income interest) or transferring an interest in that property to a noncharity for less than full and adequate consideration.<sup>290</sup> Exceptions to this

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<sup>288</sup> Sec. 170(f)(8).

<sup>289</sup> Sec. 6115.

<sup>290</sup> Secs. 170(f), 2055(e)(2), and 2522(c)(2).

general rule are provided for, among other interests, remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, and present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property.<sup>291</sup> For such interests, a charitable deduction is allowed to the extent of the present value of the interest designated for a charitable organization.

### **IRA rules**

Within limits, individuals may make deductible and nondeductible contributions to a traditional IRA. Amounts in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal represents a return of nondeductible contributions). Individuals also may make nondeductible contributions to a Roth IRA. Qualified withdrawals from a Roth IRA are excludable from gross income. Withdrawals from a Roth IRA that are not qualified withdrawals are includible in gross income to the extent attributable to earnings. Includible amounts withdrawn from a traditional IRA or a Roth IRA before attainment of age 59-½ are subject to an additional 10-percent early withdrawal tax, unless an exception applies. Under present law, minimum distributions are required to be made from tax-favored retirement arrangements, including IRAs. Minimum required distributions from a traditional IRA must generally begin by the April 1 of the calendar year following the year in which the IRA owner attains age 70-½.<sup>292</sup>

If an individual has made nondeductible contributions to a traditional IRA, a portion of each distribution from an IRA is nontaxable until the total amount of nondeductible contributions has been received. In general, the amount of a distribution that is nontaxable is determined by multiplying the amount of the distribution by the ratio of the remaining nondeductible contributions to the account balance. In making the calculation, all traditional IRAs of an individual are treated as a single IRA, all distributions during any taxable year are treated as a single distribution, and the value of the contract, income on the contract, and investment in the contract are computed as of the close of the calendar year.

In the case of a distribution from a Roth IRA that is not a qualified distribution, in determining the portion of the distribution attributable to earnings, contributions and distributions are deemed to be distributed in the following order: (1) regular Roth IRA contributions; (2) taxable conversion contributions;<sup>293</sup> (3) nontaxable conversion contributions; and (4) earnings. In determining the amount of taxable distributions from a Roth IRA, all Roth IRA distributions in the same taxable year are treated as a single distribution, all regular Roth IRA contributions for a year are treated as a single contribution, and all conversion contributions during the year are treated as a single contribution.

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<sup>291</sup> Sec. 170(f)(2).

<sup>292</sup> Minimum distribution rules also apply in the case of distributions after the death of a traditional or Roth IRA owner.

<sup>293</sup> Conversion contributions refer to conversions of amounts in a traditional IRA to a Roth IRA.

Distributions from an IRA (other than a Roth IRA) are generally subject to withholding unless the individual elects not to have withholding apply.<sup>294</sup> Elections not to have withholding apply are to be made in the time and manner prescribed by the Secretary.

### **Split-interest trust filing requirements**

Split-interest trusts, including charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, are required to file an annual information return (Form 1041A).<sup>295</sup> Trusts that are not split-interest trusts but that claim a charitable deduction for amounts permanently set aside for a charitable purpose<sup>296</sup> also are required to file Form 1041A. The returns are required to be made publicly available.<sup>297</sup> A trust that is required to distribute all trust net income currently to trust beneficiaries in a taxable year is exempt from this return requirement for such taxable year. A failure to file the required return may result in a penalty on the trust of \$10 a day for as long as the failure continues, up to a maximum of \$5,000 per return.

In addition, split-interest trusts are required to file annually Form 5227.<sup>298</sup> Form 5227 requires disclosure of information regarding a trust's noncharitable beneficiaries. The penalty for failure to file this return is calculated based on the amount of tax owed. A split-interest trust generally is not subject to tax and therefore, in general, a penalty may not be imposed for the failure to file Form 5227. Form 5227 is not required to be made publicly available.

### **Explanation of Provision**

#### **Qualified charitable distributions from IRAs**

The provision provides an exclusion from gross income for otherwise taxable IRA distributions from a traditional or a Roth IRA in the case of qualified charitable distributions.<sup>299</sup> The exclusion may not exceed \$100,000 per taxpayer per taxable year. Special rules apply in determining the amount of an IRA distribution that is otherwise taxable. The present-law rules regarding taxation of IRA distributions and the deduction of charitable contributions continue to apply to distributions from an IRA that are not qualified charitable distributions. Qualified charitable distributions are taken into account for purposes of the minimum distribution rules applicable to traditional IRAs to the same extent the distribution would have been taken into account under such rules had the distribution not been directly distributed under the provision.

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<sup>294</sup> Sec. 3405.

<sup>295</sup> Sec. 6034. This requirement applies to all split-interest trusts described in section 4947(a)(2).

<sup>296</sup> Sec. 642(c).

<sup>297</sup> Sec. 6104(b).

<sup>298</sup> Sec. 6011; Treas. Reg. sec. 53.6011-1(d).

<sup>299</sup> The provision does not apply to distributions from employer-sponsored retirements plans, including SIMPLE IRAs and simplified employee pensions ("SEPs").

An IRA does not fail to qualify as an IRA merely because qualified charitable distributions have been made from the IRA. It is intended that the Secretary will prescribe rules under which IRA owners are deemed to elect out of withholding if they designate that a distribution is intended to be a qualified charitable distribution.

A qualified charitable distribution is any distribution from an IRA directly by the IRA trustee to an organization described in section 170(b)(1)(A) (other than an organization described in section 509(a)(3) or a donor advised fund (as defined in section 4966(d)(2))). Distributions are eligible for the exclusion only if made on or after the date the IRA owner attains age 70-½.

The exclusion applies only if a charitable contribution deduction for the entire distribution otherwise would be allowable (under present law), determined without regard to the generally applicable percentage limitations. Thus, for example, if the deductible amount is reduced because of a benefit received in exchange, or if a deduction is not allowable because the donor did not obtain sufficient substantiation, the exclusion is not available with respect to any part of the IRA distribution.

If the IRA owner has any IRA that includes nondeductible contributions, a special rule applies in determining the portion of a distribution that is includible in gross income (but for the provision) and thus is eligible for qualified charitable distribution treatment. Under the special rule, the distribution is treated as consisting of income first, up to the aggregate amount that would be includible in gross income (but for the provision) if the aggregate balance of all IRAs having the same owner were distributed during the same year. In determining the amount of subsequent IRA distributions includible in income, proper adjustments are to be made to reflect the amount treated as a qualified charitable distribution under the special rule.

Distributions that are excluded from gross income by reason of the provision are not taken into account in determining the deduction for charitable contributions under section 170.

### **Qualified charitable distribution examples**

The following examples illustrate the determination of the portion of an IRA distribution that is a qualified charitable distribution. In each example, it is assumed that the requirements for qualified charitable distribution treatment are otherwise met (e.g., the applicable age requirement and the requirement that contributions are otherwise deductible) and that no other IRA distributions occur during the year.

Example 1.—Individual A has a traditional IRA with a balance of \$100,000, consisting solely of deductible contributions and earnings. Individual A has no other IRA. The entire IRA balance is distributed in a distribution to an organization described in section 170(b)(1)(A) (other than an organization described in section 509(a)(3) or a donor advised fund). Under present law, the entire distribution of \$100,000 would be includible in Individual A's income. Accordingly, under the provision, the entire distribution of \$100,000 is a qualified charitable distribution. As a result, no amount is included in Individual A's income as a result of the distribution and the distribution is not taken into account in determining the amount of Individual A's charitable deduction for the year.

**Example 2.**—Individual B has a traditional IRA with a balance of \$100,000, consisting of \$20,000 of nondeductible contributions and \$80,000 of deductible contributions and earnings. Individual B has no other IRA. In a distribution to an organization described in section 170(b)(1)(A) (other than an organization described in section 509(a)(3) or a donor advised fund), \$80,000 is distributed from the IRA. Under present law, a portion of the distribution from the IRA would be treated as a nontaxable return of nondeductible contributions. The nontaxable portion of the distribution would be \$16,000, determined by multiplying the amount of the distribution (\$80,000) by the ratio of the nondeductible contributions to the account balance (\$20,000/\$100,000). Accordingly, under present law, \$64,000 of the distribution (\$80,000 minus \$16,000) would be includible in Individual B's income.

Under the provision, notwithstanding the present-law tax treatment of IRA distributions, the distribution is treated as consisting of income first, up to the total amount that would be includible in gross income (but for the provision) if all amounts were distributed from all IRAs otherwise taken into account in determining the amount of IRA distributions. The total amount that would be includible in income if all amounts were distributed from the IRA is \$80,000. Accordingly, under the provision, the entire \$80,000 distributed to the charitable organization is treated as includible in income (before application of the provision) and is a qualified charitable distribution. As a result, no amount is included in Individual B's income as a result of the distribution and the distribution is not taken into account in determining the amount of Individual B's charitable deduction for the year. In addition, for purposes of determining the tax treatment of other distributions from the IRA, \$20,000 of the amount remaining in the IRA is treated as Individual B's nondeductible contributions (i.e., not subject to tax upon distribution).

### **Split-interest trust filing requirements**

The provision increases the penalty on split-interest trusts for failure to file a return and for failure to include any of the information required to be shown on such return and to show the correct information. The penalty is \$20 for each day the failure continues up to \$10,000 for any one return. In the case of a split-interest trust with gross income in excess of \$250,000, the penalty is \$100 for each day the failure continues up to a maximum of \$50,000. In addition, if a person (meaning any officer, director, trustee, employee, or other individual who is under a duty to file the return or include required information)<sup>300</sup> knowingly failed to file the return or include required information, then that person is personally liable for such a penalty, which would be imposed in addition to the penalty that is paid by the organization. Information regarding beneficiaries that are not charitable organizations as described in section 170(c) is exempt from the requirement to make information publicly available. In addition, the provision repeals the present-law exception to the filing requirement for split-interest trusts that are required in a taxable year to distribute all net income currently to beneficiaries. Such exception remains available to trusts other than split-interest trusts that are otherwise subject to the filing requirement.

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<sup>300</sup> Sec. 6652(c)(4)(C).

## **Effective Date**

The provision relating to qualified charitable distributions is effective for distributions made in taxable years beginning after December 31, 2005, and taxable years beginning before January 1, 2008. The provision relating to information returns of split-interest trusts is effective for returns for taxable years beginning after December 31, 2006.

## **2. Charitable deduction for contributions of food inventory (sec. 170 of the Code)**

### **Present Law**

Under present law, a taxpayer's deduction for charitable contributions of inventory generally is limited to the taxpayer's basis (typically, cost) in the inventory, or if less the fair market value of the inventory.

For certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one half of fair market value in excess of basis) or (2) two times basis (sec. 170(e)(3)). In general, a C corporation's charitable contribution deductions for a year may not exceed 10 percent of the corporation's taxable income (sec. 170(b)(2)). To be eligible for the enhanced deduction, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in section 501(c)(3) (except for private nonoperating foundations), and the donee must (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements. In the case of contributed property subject to the Federal Food, Drug, and Cosmetic Act, the property must satisfy the applicable requirements of such Act on the date of transfer and for 180 days prior to the transfer.

A donor making a charitable contribution of inventory must make a corresponding adjustment to the cost of goods sold by decreasing the cost of goods sold by the lesser of the fair market value of the property or the donor's basis with respect to the inventory (Treas. Reg. sec. 1.170A-4A(c)(3)). Accordingly, if the allowable charitable deduction for inventory is the fair market value of the inventory, the donor reduces its cost of goods sold by such value, with the result that the difference between the fair market value and the donor's basis may still be recovered by the donor other than as a charitable contribution.

To use the enhanced deduction, the taxpayer must establish that the fair market value of the donated item exceeds basis. The valuation of food inventory has been the subject of disputes between taxpayers and the IRS.<sup>301</sup>

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<sup>301</sup> *Lucky Stores Inc. v. Commissioner*, 105 T.C. 420 (1995) (holding that the value of surplus bread inventory donated to charity was the full retail price of the bread rather than half the retail price, as the IRS asserted).

Under the Katrina Emergency Tax Relief Act of 2005, any taxpayer, whether or not a C corporation, engaged in a trade or business is eligible to claim the enhanced deduction for certain donations made after August 28, 2005, and before January 1, 2006, of food inventory. For taxpayers other than C corporations, the total deduction for donations of food inventory in a taxable year generally may not exceed 10 percent of the taxpayer's net income for such taxable year from all sole proprietorships, S corporations, or partnerships (or other entity that is not a C corporation) from which contributions of "apparently wholesome food" are made. "Apparently wholesome food" is defined as food intended for human consumption that meets all quality and labeling standards imposed by Federal, State, and local laws and regulations even though the food may not be readily marketable due to appearance, age, freshness, grade, size, surplus, or other conditions.

### **Explanation of Provision**

The provision extends the provision enacted as part of the Katrina Emergency Tax Relief Act of 2005. As under such Act, under the provision, any taxpayer, whether or not a C corporation, engaged in a trade or business is eligible to claim the enhanced deduction for donations of food inventory. For taxpayers other than C corporations, the total deduction for donations of food inventory in a taxable year generally may not exceed 10 percent of the taxpayer's net income for such taxable year from all sole proprietorships, S corporations, or partnerships (or other non C corporation) from which contributions of apparently wholesome food are made. For example, as under the Katrina Emergency Tax Relief Act of 2005, if a taxpayer is a sole proprietor, a shareholder in an S corporation, and a partner in a partnership, and each business makes charitable contributions of food inventory, the taxpayer's deduction for donations of food inventory is limited to 10 percent of the taxpayer's net income from the sole proprietorship and the taxpayer's interests in the S corporation and partnership. However, if only the sole proprietorship and the S corporation made charitable contributions of food inventory, the taxpayer's deduction would be limited to 10 percent of the net income from the trade or business of the sole proprietorship and the taxpayer's interest in the S corporation, but not the taxpayer's interest in the partnership.<sup>302</sup>

Under the provision, the enhanced deduction for food is available only for food that qualifies as "apparently wholesome food." "Apparently wholesome food" is defined as it is defined under the Katrina Emergency Tax Relief Act of 2005.

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<sup>302</sup> The 10 percent limitation does not affect the application of the generally applicable percentage limitations. For example, if 10 percent of a sole proprietor's net income from the proprietor's trade or business was greater than 50 percent of the proprietor's contribution base, the available deduction for the taxable year (with respect to contributions to public charities) would be 50 percent of the proprietor's contribution base. Consistent with present law, such contributions may be carried forward because they exceed the 50 percent limitation. Contributions of food inventory by a taxpayer that is not a C corporation that exceed the 10 percent limitation but not the 50 percent limitation could not be carried forward.

### **Effective Date**

The provision is effective for contributions made after December 31, 2005, and before January 1, 2008.

### **3. Basis adjustment to stock of S corporation contributing property (sec. 1367 of the Code)**

#### **Present Law**

Under present law, if an S corporation contributes money or other property to a charity, each shareholder takes into account the shareholder's pro rata share of the contribution in determining its own income tax liability.<sup>303</sup> A shareholder of an S corporation reduces the basis in the stock of the S corporation by the amount of the charitable contribution that flows through to the shareholder.<sup>304</sup>

#### **Explanation of Provision**

The provision provides that the amount of a shareholder's basis reduction in the stock of an S corporation by reason of a charitable contribution made by the corporation will be equal to the shareholder's pro rata share of the adjusted basis of the contributed property.<sup>305</sup>

Thus, for example, assume an S corporation with one individual shareholder makes a charitable contribution of stock with a basis of \$200 and a fair market value of \$500. The shareholder will be treated as having made a \$500 charitable contribution (or a lesser amount if the special rules of section 170(e) apply), and will reduce the basis of the S corporation stock by \$200.<sup>306</sup>

### **Effective Date**

The provision applies to contributions made in taxable years beginning after December 31, 2005, and taxable years beginning before January 1, 2008.

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<sup>303</sup> Sec. 1366(a)(1)(A).

<sup>304</sup> Sec. 1367(a)(2)(B).

<sup>305</sup> See Rev. Rul. 96-11 (1996-1 C.B. 140) for a rule reaching a similar result in the case of charitable contributions made by a partnership.

<sup>306</sup> This example assumes that basis of the S corporation stock (before reduction) is at least \$200.

#### **4. Charitable deduction for contributions of book inventory (sec. 170 of the Code)**

##### **Present Law**

Under present law, a taxpayer's deduction for charitable contributions of inventory generally is limited to the taxpayer's basis (typically, cost) in the inventory, or if less the fair market value of the inventory.

For certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one half of fair market value in excess of basis) or (2) two times basis (sec. 170(e)(3)). In general, a C corporation's charitable contribution deductions for a year may not exceed 10 percent of the corporation's taxable income (sec. 170(b)(2)). To be eligible for the enhanced deduction, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in section 501(c)(3) (except for private nonoperating foundations), and the donee must (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements. In the case of contributed property subject to the Federal Food, Drug, and Cosmetic Act, the property must satisfy the applicable requirements of such Act on the date of transfer and for 180 days prior to the transfer.

A donor making a charitable contribution of inventory must make a corresponding adjustment to the cost of goods sold by decreasing the cost of goods sold by the lesser of the fair market value of the property or the donor's basis with respect to the inventory (Treas. Reg. sec. 1.170A-4A(c)(3)). Accordingly, if the allowable charitable deduction for inventory is the fair market value of the inventory, the donor reduces its cost of goods sold by such value, with the result that the difference between the fair market value and the donor's basis may still be recovered by the donor other than as a charitable contribution.

To use the enhanced deduction, the taxpayer must establish that the fair market value of the donated item exceeds basis.

The Katrina Emergency Tax Relief Act of 2005 extended the present-law enhanced deduction for C corporations to certain qualified book contributions made after August 28, 2005, and before January 1, 2006. For such purposes, a qualified book contribution means a charitable contribution of books to a public school that provides elementary education or secondary education (kindergarten through grade 12) and that is an educational organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. The enhanced deduction under the Katrina Emergency Tax Relief Act of 2005 is not allowed unless the donee organization certifies in writing that the contributed books are suitable, in terms of currency, content, and quantity, for use in the donee's educational programs and that the donee will use the books in such educational programs.

### **Explanation of Provision**

The provision extends the provision enacted as part of the Katrina Emergency Tax Relief Act of 2005. As under such Act, an enhanced deduction for C corporations for qualified book contributions is allowed.

### **Effective Date**

The provision is effective for contributions made after December 31, 2005, and before January 1, 2008.

## **5. Modify tax treatment of certain payments to controlling exempt organizations (secs. 512 and 6033 of the Code)**

### **Present Law**

In general, interest, rents, royalties, and annuities are excluded from the unrelated business income of tax-exempt organizations. However, section 512(b)(13) generally treats otherwise excluded rent, royalty, annuity, and interest income as unrelated business income if such income is received from a taxable or tax-exempt subsidiary that is 50 percent controlled by the parent tax-exempt organization. In the case of a stock subsidiary, “control” means ownership by vote or value of more than 50 percent of the stock. In the case of a partnership or other entity, control means ownership of more than 50 percent of the profits, capital or beneficial interests. In addition, present law applies the constructive ownership rules of section 318 for purposes of section 512(b)(13). Thus, a parent exempt organization is deemed to control any subsidiary in which it holds more than 50 percent of the voting power or value, directly (as in the case of a first-tier subsidiary) or indirectly (as in the case of a second-tier subsidiary).

Under present law, interest, rent, annuity, or royalty payments made by a controlled entity to a tax-exempt organization are includable in the latter organization’s unrelated business income and are subject to the unrelated business income tax to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity (determined as if the entity were tax exempt).

### **Explanation of Provision**

The provision provides that the general rule of section 512(b)(13), which includes interest, rent, annuity, or royalty payments made by a controlled entity to the controlling tax-exempt organization in the latter organization’s unrelated business income to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity, applies only to the portion of payments received or accrued in a taxable year that exceeds the amount of the specified payment that would have been paid or accrued if such payment had been determined under the principles of section 482. Thus, if a payment of rent by a controlled subsidiary to its tax-exempt parent organization exceeds fair market value, the excess amount of such payment over fair market value (as determined in accordance with section 482) is included in the parent organization’s unrelated business income, to the extent that such excess reduced the net unrelated income (or increased any net unrelated loss) of the controlled entity (determined as if the entity were tax exempt). In addition, the provision imposes a 20-percent penalty on the

larger of such excess determined without regard to any amendment or supplement to a return of tax, or such excess determined with regard to all such amendments and supplements. The provision applies only to payments made pursuant to a binding written contract in effect on the date of enactment (or renewal of such a contract on substantially similar terms). It is intended that there should be further study of such arrangements in light of the provision before any determination about whether to extend or expand the provision is made.

The provision requires that a tax-exempt organization that receives interest, rent, annuity, or royalty payments from a controlled entity report such payments on its annual information return as well as any loans made to any controlled entity and any transfers between such organization and a controlled entity.

The provision provides that, not later than January 1, 2009, the Secretary shall submit a report to the Committee on Finance of the Senate and the Committee on Ways and Means of the House of Representatives a report on the effectiveness of the Internal Revenue Service in administering the provision and on the extent to which payments by controlled entities to the controlling exempt organization meet the requirements of section 482 of the Code. Such report shall include the results of any audit of any controlling organization or controlled entity and recommendations relating to the tax treatment of payments from controlled entities to controlling organizations.

#### **Effective Date**

The provision related to payments to controlling organizations applies to payments received or accrued after December 31, 2005 and before January 1, 2008. The provision relating to reporting is effective for returns the due date (determined without regard to extensions) of which is after the date of enactment. The provision relating to a report is effective on the date of enactment.

### **6. Encourage contributions of real property made for conservation purposes (sec. 170 of the Code)**

#### **Present Law**

##### **Charitable contributions generally**

In general, a deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization. The amount of deduction generally equals the fair market value of the contributed property on the date of the contribution. Charitable deductions are provided for income, estate, and gift tax purposes.<sup>307</sup>

In general, in any taxable year, charitable contributions by a corporation are not deductible to the extent the aggregate contributions exceed 10 percent of the corporation's

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<sup>307</sup> Secs. 170, 2055, and 2522, respectively.

taxable income computed without regard to net operating or capital loss carrybacks. For individuals, the amount deductible is a percentage of the taxpayer's contribution base, which is the taxpayer's adjusted gross income computed without regard to any net operating loss carryback. The applicable percentage of the contribution base varies depending on the type of donee organization and property contributed. Cash contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer's contribution base. Cash contributions to private foundations and certain other organizations generally may be deducted up to 30 percent of the taxpayer's contribution base.

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity while also either retaining an interest in that property or transferring an interest in that property to a noncharity for less than full and adequate consideration. Exceptions to this general rule are provided for, among other interests, remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property, and qualified conservation contributions.

### **Capital gain property**

Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property to a qualified charity are deductible at fair market value within certain limitations. Contributions of capital gain property to charitable organizations described in section 170(b)(1)(A) (e.g., public charities, private foundations other than private non-operating foundations, and certain governmental units) generally are deductible up to 30 percent of the taxpayer's contribution base. An individual may elect, however, to bring all these contributions of capital gain property for a taxable year within the 50-percent limitation category by reducing the amount of the contribution deduction by the amount of the appreciation in the capital gain property. Contributions of capital gain property to charitable organizations described in section 170(b)(1)(B) (e.g., private non-operating foundations) are deductible up to 20 percent of the taxpayer's contribution base.

For purposes of determining whether a taxpayer's aggregate charitable contributions in a taxable year exceed the applicable percentage limitation, contributions of capital gain property are taken into account after other charitable contributions. Contributions of capital gain property that exceed the percentage limitation may be carried forward for five years.

### **Qualified conservation contributions**

Qualified conservation contributions are not subject to the "partial interest" rule, which generally bars deductions for charitable contributions of partial interests in property. A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. A qualified real property interest is defined as: (1) the entire interest of the donor other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use that may be made of the real

property. Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations. Conservation purposes include: (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy; and (4) the preservation of an historically important land area or a certified historic structure.

Qualified conservation contributions of capital gain property are subject to the same limitations and carryover rules of other charitable contributions of capital gain property.

### **Explanation of Provision**

#### **In general**

Under the provision, the 30-percent contribution base limitation on contributions of capital gain property by individuals does not apply to qualified conservation contributions (as defined under present law). Instead, individuals may deduct the fair market value of any qualified conservation contribution to an organization described in section 170(b)(1)(A) to the extent of the excess of 50 percent of the contribution base over the amount of all other allowable charitable contributions. These contributions are not taken into account in determining the amount of other allowable charitable contributions.

Individuals are allowed to carryover any qualified conservation contributions that exceed the 50-percent limitation for up to 15 years.

For example, assume an individual with a contribution base of \$100 makes a qualified conservation contribution of property with a fair market value of \$80 and makes other charitable contributions subject to the 50-percent limitation of \$60. The individual is allowed a deduction of \$50 in the current taxable year for the non-conservation contributions (50 percent of the \$100 contribution base) and is allowed to carryover the excess \$10 for up to 5 years. No current deduction is allowed for the qualified conservation contribution, but the entire \$80 qualified conservation contribution may be carried forward for up to 15 years.

#### **Farmers and ranchers**

##### **Individuals**

In the case of an individual who is a qualified farmer or rancher for the taxable year in which the contribution is made, a qualified conservation contribution is allowable up to 100 percent of the excess of the taxpayer's contribution base over the amount of all other allowable charitable contributions.

In the above example, if the individual is a qualified farmer or rancher, in addition to the \$50 deduction for non-conservation contributions, an additional \$50 for the qualified

conservation contribution is allowed and \$30 may be carried forward for up to 15 years as a contribution subject to the 100-percent limitation.

### Corporations

In the case of a corporation (other than a publicly traded corporation) that is a qualified farmer or rancher for the taxable year in which the contribution is made, any qualified conservation contribution is allowable up to 100 percent of the excess of the corporation's taxable income (as computed under section 170(b)(2)) over the amount of all other allowable charitable contributions. Any excess may be carried forward for up to 15 years as a contribution subject to the 100-percent limitation.

### Requirement that land be available for agriculture or livestock production

As an additional condition of eligibility for the 100 percent limitation, with respect to any contribution of property in agriculture or livestock production, or that is available for such production, by a qualified farmer or rancher, the qualified real property interest must include a restriction that the property remain generally available for such production. (There is no requirement as to any specific use in agriculture or farming, or necessarily that the property be used for such purposes, merely that the property remain available for such purposes.) Such additional condition does not apply to contributions made after December 31, 2005, and on or before the date of enactment.

### Definition

A qualified farmer or rancher means a taxpayer whose gross income from the trade of business of farming (within the meaning of section 2032A(e)(5)) is greater than 50 percent of the taxpayer's gross income for the taxable year.

### Effective Date

The provision applies to contributions made in taxable years beginning after December 31, 2005, and before January 1, 2008.

## **7. Excise tax exemptions for blood collector organizations (secs. 4041, 4221, 4253, 4483, 6416, and 7701 of the Code)**

### Present Law

#### American National Red Cross

The American National Red Cross ("Red Cross") is a Congressionally chartered corporation. It is responsible for giving aid to members of the U.S. Armed Forces, to disaster victims in the United States and abroad to help people prevent, prepare for, and respond to

emergencies.<sup>308</sup> The Red Cross is responsible for over half of the nation's blood supply and blood products.

Exemption from certain retail and manufacturers excise taxes

The Code permits the Secretary to exempt from excise tax certain articles and services to be purchased for the exclusive use of the United States (sec. 4293). This authority is conditioned upon the Secretary determining (1) that the imposition of such taxes will cause substantial burden or expense which can be avoided by granting tax exemption and (2) that full benefit of such exemption, if granted, will accrue to the United States.

On April 18, 1979, the Secretary exercised this authority to exempt, with limited exceptions, the Red Cross from the taxes imposed by chapters 31 and 32 of the Code with respect to articles sold to the Red Cross for its exclusive use.<sup>309</sup> An exemption is also authorized from the taxes imposed with respect to tires and inner tubes if such tire or inner tube is sold by any person on or in connection with the sale of any article to the American National Red Cross, for its exclusive use.<sup>310</sup> No exemption is provided from the gas guzzler tax (sec. 4064), and the taxes imposed on aviation fuel, on fuel used on inland waterways (sec. 4042), and on coal (sec. 4121).<sup>311</sup> The exemption is subject to registration requirements for tax-free sales contained in Treasury regulations. Credit and refund of tax is subject to the requirements set forth in section 6416 relating to the exemption for taxable articles sold for the exclusive use of State and local governments.

Exemption from heavy highway motor vehicle use tax

An annual use tax is imposed on highway motor vehicles, at the rates below (sec. 4481).

Under 55,000 pounds	No tax
55,000-75,000 pounds	\$100 plus \$22 per 1,000 pounds over 55,000
Over 75,000 pounds	\$550

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<sup>308</sup> See 36 U.S.C. sec. 300102.

<sup>309</sup> Department of the Treasury, *Notice-Manufacturers and Retailers Excise Taxes -Exemption from Tax of Sales of Certain Articles to the American Red Cross*, 44 F.R. 23407, 1979-1 C.B. 478 (1979). At the time the notice was issued the following taxes were covered in Chapters 31 and 32: special fuels, automotive and related items (motor vehicles, tires and tubes, petroleum products, coal, and recreational equipment (sporting goods and firearms).

<sup>310</sup> Under present law, there is no longer a tax on inner tubes.

<sup>311</sup> Department of the Treasury, *Notice-Manufacturers and Retailers Excise Taxes -Exemption from Tax of Sales of Certain Articles to the American Red Cross*, 44 F.R. 23407, 1979-1 C.B. 478, at 479 (1979). The Treasury notice also exempts the Red Cross from tax on aircraft tires and tubes, however, present law currently limits the tax to highway vehicle tires (sec. 4071(a)).

The Code provides that the Secretary may authorize exemption from the heavy highway vehicle use tax as to the use by the United States of any particular highway motor vehicle or class of highway motor vehicles if the Secretary determines that the imposition of such tax with respect to such use will cause substantial burden or expense which can be avoided by granting tax exemption and that the full benefit of such exemption, if granted will accrue to the United States (sec. 4483(b)). The IRS has ruled that the Red Cross comes within the term “United States” for purposes of the exemption from the heavy highway motor vehicle use tax (Rev. Rul. 76-510).

#### Exemption from communications excise tax

The Code imposes a three-percent tax on amounts paid for local telephone service; toll telephone service and teletypewriter exchange service (sec. 4251). These taxes do not apply to amounts paid for services furnished to the Red Cross (sec. 4253(c)).

#### **Certain other tax-free sales**

##### Exemption from certain manufacturer and retail sale excise taxes

The following sales generally are exempt from certain manufacturer and retail sale excise taxes: (1) for use by the purchaser for further manufacture, or for resale to a second purchaser in further manufacture; (2) for export or for resale to a second purchaser for export; (3) for use by the purchaser as supplies for vessels or aircraft; (4) to a State or local government for the exclusive use of a State or local government; and (5) to a nonprofit educational organization for its exclusive use (sec. 4221). The exemption generally applies to manufacturers taxes imposed by chapter 32 of the Code (the gas guzzlers tax, and the taxes imposed on tires, certain vaccines, and recreational equipment) and the tax on retail sales of heavy trucks and trailers.<sup>312</sup>

The manufacturers excise taxes on coal (sec. 4121), on gasoline, diesel fuel, and kerosene (sec. 4081) are not covered by the exemption. The exemption for a sale to a State or local government for their exclusive use and the exemption for sales to a nonprofit educational organization does not apply to the gas guzzlers tax, and the tax on vaccines. In addition, the exemption of sales for use as supplies for vessels and aircraft does not apply to the vaccine tax.

##### Exempt sales of special fuels

A retail excise tax is imposed on special motor fuels, including propane, compressed natural gas, and certain alcohol mixtures (sec. 4041). Section 4041 also serves as a back-up tax for diesel fuel or kerosene that was not subject to the manufacturers taxes under section 4081 (other than the Leaking Underground Storage Tank Trust Fund tax) if such fuel is delivered into

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<sup>312</sup> The tax imposed by subchapter A of chapter 31 (relating to luxury passenger vehicles) are also exempt pursuant to this provision, however, this tax expired on December 31, 2002. (sec. 4001(g).)

the fuel supply tank of a diesel-powered highway vehicle or train.<sup>313</sup> No tax is imposed on these fuels for nontaxable uses, including fuel: (1) sold for use or used as supplies for vessels or aircraft, (2) sold for the exclusive use of any State, any political subdivision of a State, or the District of Columbia or used by such entity as fuel, (3) sold for export, or for shipment to a possession of the United States and is actually exported or shipped, (4) sold to a nonprofit educational organization for its exclusive use, or used by such entity as fuel (sec. 4041(g)).

## **Credits and refunds**

### **In general**

A credit or refund is allowed for overpayment of manufacturers or retail excise taxes (sec. 6416). Overpayments include (1) certain uses and resales, (2) price adjustments, and (3) further manufacture.

### **Specified uses and resales**

The special fuel taxes, the retail tax on heavy trucks and trailers, and any of the manufacturers excise taxes paid on any article will be a deemed overpayment subject to credit or refund if sold for certain specified uses (sec. 6416(b)(2)). These uses are (1) export, (2) used or sold for use as supplies for vessels or aircraft, (3) sold to a State or local government for the exclusive use of a State or local government, (4) sold to a nonprofit educational organization for its exclusive use; (5) taxable tires sold to any person for use in connection with a qualified bus, or (6) the case of gasoline used or sold for use in the production of a special fuel. Certain exceptions apply in that this deemed overpayment rule does not apply to the taxes imposed by sections 4041 and 4081 on diesel fuel and kerosene, and the coal taxes (sec. 4121). Additionally, the deemed overpayment rule does not apply to the gas guzzler tax in the case of an article sold to a state or local government for its exclusive use or sold to an educational organization for its exclusive use.

### **Special rule for tires sold in connection with other articles**

If the tax imposed on tires (sec. 4071) has been paid with respect to the sale of any tire by the manufacturer, producer, or importer, and such tire is sold by any person in connection with the sale of any other article, such tax will be deemed an overpayment by person if such other article (1) is an automobile bus chassis or an automobile bus body, or (2) is by any person exported, sold to a State or local government for exclusive use of a State or local government, sold to a nonprofit educational organization for its exclusive use, or used or sold for use as supplies for vessels or aircraft (sec. 6416(b)(4)).

### **Gasoline used for exempt purposes**

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<sup>313</sup> For example, tax is imposed on the delivery of any of the following into the fuel supply tank of a diesel powered highway vehicle or train of any dyed diesel or dyed kerosene for other than a nontaxable use; any undyed diesel fuel or undyed kerosene on which a credit or refund.

If gasoline is sold to any person for certain specified purposes, the Secretary is required to pay (without interest) to such person an amount equal to the product of the number of gallons of gasoline so sold multiplied by the rate at which tax was imposed on such gasoline under section 4081 (sec. 6421(c)). Under this provision, the specified purposes are (1) for export or for resale to a second purchaser for export; (2) for use by the purchaser as supplies for vessels or aircraft; (3) to a State or local government for exclusive use of a State or local government; and (4) to a nonprofit educational organization for its exclusive use (sec. 4221(a), 6421(c)).

#### Diesel fuel or kerosene used in a nontaxable use

If diesel fuel or kerosene, upon which tax has been imposed is used by any person in a nontaxable use, the Code authorizes the Secretary to pay (without interest) an amount equal to the aggregate amount of tax imposed on such fuel (sec. 6427(l)). Nontaxable uses include any exemption from the tax imposed by section 4041(a) (except prior taxation).

#### **Explanation of Provision**

The provision exempts qualified blood collector organizations from certain retail and manufacturers excise taxes to the extent such items are for the exclusive use of such an organization for the distribution or collection of blood. A qualified blood collector organization means an organization that is (1) described in section 501(c)(3) and exempt from tax under section 501(a), (2) primarily engaged in the activity of the collection of blood, (3) registered with the Secretary for purposes of excise tax exemptions, and (4) registered by the Food and Drug Administration to collect blood.

Under the provision, qualified blood collector organizations are exempt from the communications excise tax as provided by Treasury regulations. The provision also provides an exemption from the special fuels tax, and certain taxes imposed by chapter 32 and subchapter A and C of chapter 31 of the Code (i.e., the retail excise tax on heavy trucks and trailers, and the manufacturers excise taxes on tires).<sup>314</sup> The provision also makes conforming amendments to allow for the credit or refund of these taxes and any tax paid on gasoline for the exclusive use of the blood collector organization. The provision also permits a refund of tax for diesel fuel or kerosene used by a qualified blood collector organization. Finally, the provision provides an exemption from the heavy vehicle use tax of a “qualified blood collector vehicle” by a qualified blood collector organization. A “qualified blood collector vehicle” means a vehicle at least 80 percent of the use of which during the prior taxable period was by a qualified blood collector organization in the collection, storage, or transportation of blood. A special rule is provided for the first taxable period a vehicle is placed in service by the qualified blood collector organization. For the first taxable period a vehicle is placed in service by the organization, the vehicle will be treated as a “qualified blood collector vehicle” for that period if the organization certifies that it reasonably expects that at least 80 percent of the use of the vehicle during such

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<sup>314</sup> Such organizations are also exempt from the expired retail excise tax on luxury passenger vehicles. No exemption is provided from the gas guzzler tax (sec. 4064), the taxes imposed on fuel used on inland waterways (sec. 4042), on coal (sec. 4121), and on recreational equipment (sport fishing equipment, bows, arrow components, and firearms).

taxable period will be by the organization in the collection, storage, or transportation of blood. Such certification is to be provided to the Secretary on such forms and in such manner as the Secretary may require.

It is expected that the excise tax exemptions of the Red Cross will be reexamined in conjunction with a review of its charter.

#### **Effective Date**

Generally, the provision is effective on January 1, 2007. The exemption from the heavy vehicle use tax is effective for taxable periods beginning July 1, 2007.

## **B. Reforming Exempt Organizations**

### **1. Reporting on certain acquisitions of interests in insurance contracts in which certain exempt organizations hold interests (new sec. 6050V of the Code)**

#### **Present Law**

##### **Amounts received under a life insurance contract**

Amounts received under a life insurance contract paid by reason of the death of the insured are not includible in gross income for Federal tax purposes.<sup>315</sup> No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract (inside buildup).<sup>316</sup>

Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income to the extent that the amounts distributed exceed the taxpayer's investment in the contract (i.e., basis). Such distributions generally are treated first as a tax-free recovery of basis, and then as income.<sup>317</sup>

##### **Transfers for value**

A limitation on the exclusion for amounts received under a life insurance contract is provided in the case of transfers for value. If a life insurance contract (or an interest in the contract) is transferred for valuable consideration, the amount excluded from income by reason of the death of the insured is limited to the actual value of the consideration plus the premiums and other amounts subsequently paid by the acquiror of the contract.<sup>318</sup>

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<sup>315</sup> Sec. 101(a).

<sup>316</sup> This favorable tax treatment is available only if a life insurance contract meets certain requirements designed to limit the investment character of the contract. Sec. 7702.

<sup>317</sup> Sec. 72(e). In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10-percent tax is imposed on the income portion of distributions made before age 59-½ and in certain other circumstances. Secs. 72(e) and (v). A modified endowment contract is a life insurance contract that does not meet a statutory "7-pay" test, i.e., generally is funded more rapidly than seven annual level premiums. Sec. 7702A.

<sup>318</sup> Section 101(a)(2). The transfer-for-value rule does not apply, however, in the case of a transfer in which the life insurance contract (or interest in the contract) transferred has a basis in the hands of the transferee that is determined by reference to the transferor's basis. Similarly, the transfer-for-value rule generally does not apply if the transfer is between certain parties (specifically, if the transfer is to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer).

## **Tax treatment of charitable organizations and donors**

Present law generally provides tax-exempt status for charitable, educational and certain other organizations, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and which meet certain other requirements.<sup>319</sup> Governmental entities, including some educational organizations, are exempt from tax on income under other tax rules providing that gross income does not include income derived from the exercise of any essential governmental function and accruing to a State or any political subdivision thereof.<sup>320</sup>

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and the fair market value of property contributed to an organization described in section 501(c)(3) or to a Federal, State, or local governmental entity for exclusively public purposes.<sup>321</sup>

## **State-law insurable interest rules**

State laws generally provide that the owner of a life insurance contract must have an insurable interest in the insured person when the life insurance contract is issued. State laws vary as to the insurable interest of a charitable organization in the life of any individual. Some State laws provide that a charitable organization meeting the requirements of section 501(c)(3) of the Code is treated as having an insurable interest in the life of any donor,<sup>322</sup> or, in other States, in the life of any individual who consents (whether or not the individual is a donor).<sup>323</sup> Other States' insurable interest rules permit the purchase of a life insurance contract even though the person paying the consideration has no insurable interest in the life of the person insured if a charitable, benevolent, educational or religious institution is designated irrevocably as the beneficiary.<sup>324</sup>

## **Transactions involving charities and non-charities acquiring life insurance**

Recently, there has been an increase in transactions involving the acquisition of life insurance contracts using arrangements in which both exempt organizations, primarily charities,

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<sup>319</sup> Section 501(c)(3).

<sup>320</sup> Section 115.

<sup>321</sup> Section 170.

<sup>322</sup> See, e.g., Mass. Gen. Laws Ann. ch. 175, sec. 123A(2) (West 2005); Iowa Code Ann. sec. 511.39 (West 2004) ("a person who, when purchasing a life insurance policy, makes a donation to the charitable organization or makes the charitable organization the beneficiary of all or a part of the proceeds of the policy . . . ).

<sup>323</sup> See, e.g., Cal. Ins. Code sec. 10110.1(f) (West 2005); 40 Pa. Cons. Stat. Ann. sec. 40-512 (2004); Fla. Stat. Ann. sec. 27.404 (2) (2004); Mich. Comp. Laws Ann. sec. 500.2212 (West 2004).

<sup>324</sup> Or. Rev. Stat. sec. 743.030 (2003); Del. Code Ann. Tit. 18, sec. 2705(a) (2004).

and private investors have an interest in the contract.<sup>325</sup> The exempt organization has an insurable interest in the insured individuals, either because they are donors, because they consent, or otherwise under applicable State insurable interest rules. Private investors provide capital used to fund the purchase of the life insurance contracts, sometimes together with annuity contracts. Both the private investors and the charity have an interest in the contracts, directly or indirectly, through the use of trusts, partnerships, or other arrangements for sharing the rights to the contracts. Both the charity and the private investors receive cash amounts in connection with the investment in the contracts while the life insurance is in force or as the insured individuals die.

### **Explanation of Provision**

The provision includes a temporary reporting requirement with respect to the acquisition of interests in certain life insurance contracts by certain exempt organizations, together with a Treasury study.

The provision provides that, for reportable acquisitions occurring after the date of enactment and on or before the date two years from the date of enactment, an applicable exempt organization that makes a reportable acquisition is required to file an information return. The information return is to contain the name, address, and taxpayer identification number of the organization and of the issuer of the applicable insurance contract, and such other information as the Secretary of the Treasury prescribes. It is intended that the Treasury Department may require the reporting of other information relevant to the study required under the provision. The report is to be in the form prescribed by the Treasury Secretary and is required to be filed at the time established by the Treasury Secretary. It is intended that the Treasury Department may require the report to be filed within a certain period after the reportable acquisition takes place in order to gather information in a timely manner that is relevant to the study required under the provision.

For this purpose, a reportable acquisition means the acquisition by an applicable exempt organization of a direct or indirect interest in a contract that the applicable exempt organization knows or has reason to know is an applicable insurance contract, if such acquisition is a part of a structured transaction involving a pool of such contracts.

An applicable insurance contract means any life insurance, annuity, or endowment contract with respect to which both an applicable exempt organization and a person other than an applicable exempt organization have directly or indirectly held an interest in the contract (whether or not at the same time). Exceptions apply under this definition. First, the term does not apply if each person (other than an applicable exempt organization) with a direct or indirect interest in the contract has an insurable interest in the insured independent of any interest of the exempt organization in the contract. Second, the term does not apply if the sole interest in the contract of the applicable exempt organization or each person other than the applicable exempt

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<sup>325</sup> Davis, Wendy, "Death-Pool Donations," *Trusts and Estates*, May 2004, 55; Francis, Theo, "Tax May Thwart Investment Plans Enlisting Charities," *Wall St. J.*, Feb. 8, 2005, A-10.

organization is as a named beneficiary. Third, the term does not apply if the sole interest in the contract of each person other than the applicable exempt organization is either (1) as a beneficiary of a trust holding an interest in the contract, but only if the person's designation as such a beneficiary was made without consideration and solely on a purely gratuitous basis, or (2) as a trustee who holds an interest in the contract in a fiduciary capacity solely for the benefit of applicable exempt organizations or of persons otherwise meeting one of the first two exceptions.

An applicable exempt organization is any organization described in section 170(c), 168(h)(2)(A)(iv), 2055(a), or 2522(a). Thus, for example, an applicable exempt organization generally includes an organization that is exempt from Federal income tax by reason of being described in section 501(c)(3) (including one organized outside the United States), a government or political subdivision of a government, and an Indian tribal government.

Under the provision, penalties apply for failure to file the return.

The reporting requirement terminates with respect to reportable acquisitions occurring after the date that is 2 years after the date of enactment.

The provision requires the Treasury Secretary to undertake a study on the use by tax-exempt organizations of applicable insurance contracts for the purpose of sharing the benefits of the organization's insurable interest in insured individuals under such contracts with investors, and whether such activities are consistent with the tax-exempt status of the organizations. The study may, for example, address whether certain such arrangements are or may be used to improperly shelter income from tax, and whether they should be listed transactions within the meaning of Treasury Regulation section 1.6011-4(b)(2). No later than 30 months after the date of enactment, the Treasury Secretary is required to report on the study to the Committee on Finance of the Senate and the Committee on Ways and Means of the House of Representatives.

### **Effective Date**

The reporting provision is effective for acquisitions of contracts after the date of enactment. The study provision is effective on the date of enactment.

**2. Increase the amounts of excise taxes imposed relating to public charities, social welfare organizations, and private foundations (secs. 4941, 4942, 4943, 4944, 4945, and 4958 of the Code)**

### **Present Law**

#### **Public charities and social welfare organizations**

The Code imposes excise taxes on excess benefit transactions between disqualified persons (as defined in section 4958(f)) and charitable organizations (other than private

foundations) or social welfare organizations (as described in section 501(c)(4)).<sup>326</sup> An excess benefit transaction generally is a transaction in which an economic benefit is provided by a charitable or social welfare organization directly or indirectly to or for the use of a disqualified person, if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit.

The excess benefit tax is imposed on the disqualified person and, in certain cases, on the organization manager, but is not imposed on the exempt organization. An initial tax of 25 percent of the excess benefit amount is imposed on the disqualified person that receives the excess benefit. An additional tax on the disqualified person of 200 percent of the excess benefit applies if the violation is not corrected. A tax of 10 percent of the excess benefit (not to exceed \$10,000 with respect to any excess benefit transaction) is imposed on an organization manager that knowingly participated in the excess benefit transaction, if the manager's participation was willful and not due to reasonable cause, and if the initial tax was imposed on the disqualified person.<sup>327</sup> If more than one person is liable for the tax on disqualified persons or on management, all such persons are jointly and severally liable for the tax.<sup>328</sup>

## **Private foundations**

### Self-dealing by private foundations

Excise taxes are imposed on acts of self-dealing between a disqualified person (as defined in section 4946) and a private foundation.<sup>329</sup> In general, self-dealing transactions are any direct or indirect: (1) sale or exchange, or leasing, of property between a private foundation and a disqualified person; (2) lending of money or other extension of credit between a private foundation and a disqualified person; (3) the furnishing of goods, services, or facilities between a private foundation and a disqualified person; (4) the payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person; (5) the transfer to, or use by or for the benefit of, a disqualified person of the income or assets of the private foundation; and (6) certain payments of money or property to a government official.<sup>330</sup> Certain exceptions apply.<sup>331</sup>

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<sup>326</sup> Sec. 4958. The excess benefit transaction tax commonly is referred to as "intermediate sanctions," because it imposes penalties generally considered to be less punitive than revocation of the organization's exempt status.

<sup>327</sup> Sec. 4958(d)(2). Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

<sup>328</sup> Sec. 4958(d)(1).

<sup>329</sup> Sec. 4941.

<sup>330</sup> Sec. 4941(d)(1).

<sup>331</sup> See sec. 4941(d)(2).

An initial tax of five percent of the amount involved with respect to an act of self-dealing is imposed on any disqualified person (other than a foundation manager acting only as such) who participates in the act of self-dealing. If such a tax is imposed, a 2.5-percent tax of the amount involved is imposed on a foundation manager who participated in the act of self-dealing knowing it was such an act (and such participation was not willful and was due to reasonable cause) up to \$10,000 per act. Such initial taxes may not be abated.<sup>332</sup> Such initial taxes are imposed for each year in the taxable period, which begins on the date the act of self-dealing occurs and ends on the earliest of the date of mailing of a notice of deficiency for the tax, the date on which the tax is assessed, or the date on which correction of the act of self-dealing is completed. A government official (as defined in section 4946(c)) is subject to such initial tax only if the official participates in the act of self-dealing knowing it is such an act. If the act of self-dealing is not corrected, a tax of 200 percent of the amount involved is imposed on the disqualified person and a tax of 50 percent of the amount involved (up to \$10,000 per act) is imposed on a foundation manager who refused to agree to correcting the act of self-dealing. Such additional taxes are subject to abatement.<sup>333</sup>

#### Tax on failure to distribute income

Private nonoperating foundations are required to pay out a minimum amount each year as qualifying distributions. In general, a qualifying distribution is an amount paid to accomplish one or more of the organization's exempt purposes, including reasonable and necessary administrative expenses.<sup>334</sup> Failure to pay out the minimum results in an initial excise tax on the foundation of 15 percent of the undistributed amount. An additional tax of 100 percent of the undistributed amount applies if an initial tax is imposed and the required distributions have not been made by the end of the applicable taxable period.<sup>335</sup> A foundation may include as a qualifying distribution the salaries, occupancy expenses, travel costs, and other reasonable and necessary administrative expenses that the foundation incurs in operating a grant program. A qualifying distribution also includes any amount paid to acquire an asset used (or held for use) directly in carrying out one or more of the organization's exempt purposes and certain amounts set-aside for exempt purposes.<sup>336</sup> Private operating foundations are not subject to the payout requirements.

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<sup>332</sup> Sec. 4962(b).

<sup>333</sup> Sec. 4961.

<sup>334</sup> Sec. 4942(g)(1)(A).

<sup>335</sup> Sec. 4942(a) and (b). Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

<sup>336</sup> Sec. 4942(g)(1)(B) and 4942(g)(2). In general, an organization is permitted to adjust the distributable amount in those cases where distributions during the five preceding years have exceeded the payout requirements. Sec. 4942(i).

### Tax on excess business holdings

Private foundations are subject to tax on excess business holdings.<sup>337</sup> In general, a private foundation is permitted to hold 20 percent of the voting stock in a corporation, reduced by the amount of voting stock held by all disqualified persons (as defined in section 4946). If it is established that no disqualified person has effective control of the corporation, a private foundation and disqualified persons together may own up to 35 percent of the voting stock of a corporation. A private foundation shall not be treated as having excess business holdings in any corporation if it owns (together with certain other related private foundations) not more than two percent of the voting stock and not more than two percent in value of all outstanding shares of all classes of stock in that corporation. Similar rules apply with respect to holdings in a partnership (“profits interest” is substituted for “voting stock” and “capital interest” for “nonvoting stock”) and to other unincorporated enterprises (by substituting “beneficial interest” for “voting stock”). Private foundations are not permitted to have holdings in a proprietorship. Foundations generally have a five-year period to dispose of excess business holdings (acquired other than by purchase) without being subject to tax.<sup>338</sup> This five-year period may be extended an additional five years in limited circumstances.<sup>339</sup> The excess business holdings rules do not apply to holdings in a functionally related business or to holdings in a trade or business at least 95 percent of the gross income of which is derived from passive sources.<sup>340</sup>

The initial tax is equal to five percent of the value of the excess business holdings held during the foundation’s applicable taxable year. An additional tax is imposed if an initial tax is imposed and at the close of the applicable taxable period, the foundation continues to hold excess business holdings. The amount of the additional tax is equal to 200 percent of such holdings.

### Tax on jeopardizing investments

Private foundations and foundation managers are subject to tax on investments that jeopardize the foundation’s charitable purpose.<sup>341</sup> In general, an initial tax of five percent of the amount of the investment applies to the foundation and to foundation managers who participated in the making of the investment knowing that it jeopardized the carrying out of the foundation’s exempt purposes. The initial tax on foundation managers may not exceed \$5,000 per investment. If the investment is not removed from jeopardy (e.g., sold or otherwise disposed of), an additional tax of 25 percent of the amount of the investment is imposed on the foundation and five percent of the amount of the investment on a foundation manager who refused to agree to removing the investment from jeopardy. The additional tax on foundation managers may not exceed \$10,000 per investment. An investment, the primary purpose of which is to accomplish a

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<sup>337</sup> Sec. 4943. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

<sup>338</sup> Sec. 4943(c)(6).

<sup>339</sup> Sec. 4943(c)(7).

<sup>340</sup> Sec. 4943(d)(3).

<sup>341</sup> Sec. 4944. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

charitable purpose and no significant purpose of which is the production of income or the appreciation of property, is not considered a jeopardizing investment.<sup>342</sup>

### Tax on taxable expenditures

Certain expenditures of private foundations are subject to tax.<sup>343</sup> In general, taxable expenditures are expenses: (1) for lobbying; (2) to influence the outcome of a public election or carry on a voter registration drive (unless certain requirements are met); (3) as a grant to an individual for travel, study, or similar purposes unless made pursuant to procedures approved by the Secretary; (4) as a grant to an organization that is not a public charity or exempt operating foundation unless the foundation exercises expenditure responsibility<sup>344</sup> with respect to the grant; or (5) for any non-charitable purpose. For each taxable expenditure, a tax is imposed on the foundation of 10 percent of the amount of the expenditure, and an additional tax of 100 percent is imposed on the foundation if the expenditure is not corrected. A tax of 2.5 percent of the expenditure (up to \$5,000) also is imposed on a foundation manager who agrees to making a taxable expenditure knowing that it is a taxable expenditure. An additional tax of 50 percent of the amount of the expenditure (up to \$10,000) is imposed on a foundation manager who refuses to agree to correction of such expenditure.

### Explanation of Provision

#### Self-dealing and excess benefit transaction initial taxes and dollar limitations

For acts of self-dealing by a private foundation to a disqualified person, the provision increases the initial tax on the self-dealer from five percent of the amount involved to 10 percent of the amount involved. The provision increases the initial tax on foundation managers from 2.5 percent of the amount involved to five percent of the amount involved and increases the dollar limitation on the amount of the initial and additional taxes on foundation managers per act of self-dealing from \$10,000 per act to \$20,000 per act. Similarly, the provision doubles the dollar limitation on organization managers of public charities and social welfare organizations for participation in excess benefit transactions from \$10,000 per transaction to \$20,000 per transaction.

#### Failure to distribute income, excess business holdings, jeopardizing investments, and taxable expenditures

The provision doubles the amounts of the initial taxes and the dollar limitations on foundation managers with respect to the private foundation excise taxes on the failure to distribute income, excess business holdings, jeopardizing investments, and taxable expenditures.

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<sup>342</sup> Sec. 4944(c).

<sup>343</sup> Sec. 4945. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

<sup>344</sup> In general, expenditure responsibility requires that a foundation make all reasonable efforts and establish reasonable procedures to ensure that the grant is spent solely for the purpose for which it was made, to obtain reports from the grantee on the expenditure of the grant, and to make reports to the Secretary regarding such expenditures. Sec. 4945(h).

Specifically, for the failure to distribute income, the initial tax on the foundation is increased from 15 percent of the undistributed amount to 30 percent of the undistributed amount.

For excess business holdings, the initial tax on excess business holdings is increased from five percent of the value of such holdings to 10 percent of such value.

For jeopardizing investments, the initial tax of five percent of the amount of the investment that is imposed on the foundation and on foundation managers is increased to 10 percent of the amount of the investment. The dollar limitation on the initial tax on foundation managers of \$5,000 per investment is increased to \$10,000 and the dollar limitation on the additional tax on foundation managers of \$10,000 per investment is increased to \$20,000.

For taxable expenditures, the initial tax on the foundation is increased from 10 percent of the amount of the expenditure to 20 percent, the initial tax on the foundation manager is increased from 2.5 percent of the amount of the expenditure to five percent, the dollar limitation on the initial tax on foundation managers is increased from \$5,000 to \$10,000, and the dollar limitation on the additional tax on foundation managers is increased from \$10,000 to \$20,000.

### **Effective Date**

The provision is effective for taxable years beginning after the date of enactment.

## **3. Reform rules for charitable contributions of easements in registered historic districts and take account of rehabilitation credit in easement donations (sec. 170 of the Code)**

### **Present Law**

#### **In general**

Present law provides special rules that apply to charitable deductions of qualified conservation contributions, which include conservation easements and façade easements.<sup>345</sup> Qualified conservation contributions are not subject to the “partial interest” rule, which generally bars deductions for charitable contributions of partial interests in property.<sup>346</sup> Accordingly, qualified conservation contributions are contributions of partial interests that are eligible for a fair market value charitable deduction.

A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. A qualified real property interest is defined as: (1) the entire interest of the donor other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use that may be made

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<sup>345</sup> Sec. 170(h).

<sup>346</sup> Sec. 170(f)(3).

of the real property.<sup>347</sup> Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations.

Conservation purposes include: (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy; and (4) the preservation of an historically important land area or a certified historic structure.<sup>348</sup>

In general, no deduction is available if the property may be put to a use that is inconsistent with the conservation purpose of the gift.<sup>349</sup> A contribution is not deductible if it accomplishes a permitted conservation purpose while also destroying other significant conservation interests.<sup>350</sup>

Taxpayers are required to obtain a qualified appraisal for donated property with a value of \$5,000 or more, and to attach an appraisal summary to the tax return.<sup>351</sup> Under Treasury regulations, a qualified appraisal means an appraisal document that, among other things: (1) relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property and not later than the due date (including extensions) of the return on which a deduction is first claimed under section 170,<sup>352</sup> (2) is prepared, signed, and dated by a qualified appraiser; (3) includes (a) a description of the property appraised; (b) the fair market value of such property on the date of contribution and the specific basis for the valuation; (c) a statement that such appraisal was prepared for income tax purposes; (d) the qualifications of the qualified appraiser; and (e) the signature and taxpayer identification number of such appraiser; and (4) does not involve an appraisal fee that violates certain prescribed rules.<sup>353</sup>

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<sup>347</sup> Charitable contributions of interests that constitute the taxpayer's entire interest in the property are not regarded as qualified real property interests within the meaning of section 170(h), but instead are subject to the general rules applicable to charitable contributions of entire interests of the taxpayer (i.e., generally are deductible at fair market value, without regard to satisfaction of the requirements of section 170(h)).

<sup>348</sup> Sec. 170(h)(4)(A).

<sup>349</sup> Treas. Reg. sec. 1.170A-14(e)(2).

<sup>350</sup> Treas. Reg. sec. 1.170A-14(e)(2).

<sup>351</sup> Sec. 170(f)(11)(C).

<sup>352</sup> In the case of a deduction first claimed or reported on an amended return, the deadline is the date on which the amended return is filed.

<sup>353</sup> Treas. Reg. sec. 1.170A-13(c)(3).

## **Valuation**

The value of a conservation restriction granted in perpetuity generally is determined under the “before and after approach.” Such approach provides that the fair market value of the restriction is equal to the difference (if any) between the fair market value of the property the restriction encumbers before the restriction is granted and the fair market value of the encumbered property after the restriction is granted.<sup>354</sup>

If the granting of a perpetual restriction has the effect of increasing the value of any other property owned by the donor or a related person, the amount of the charitable deduction for the conservation contribution is to be reduced by the amount of the increase in the value of the other property.<sup>355</sup> In addition, the donor is to reduce the amount of the charitable deduction by the amount of financial or economic benefits that the donor or a related person receives or can reasonably be expected to receive as a result of the contribution.<sup>356</sup> If such benefits are greater than those that will inure to the general public from the transfer, no deduction is allowed.<sup>357</sup> In those instances where the grant of a conservation restriction has no material effect on the value of the property, or serves to enhance, rather than reduce, the value of the property, no deduction is allowed.<sup>358</sup>

## **Preservation of a certified historic structure**

A certified historic structure means any building, structure, or land which is (i) listed in the National Register, or (ii) located in a registered historic district (as defined in section 47(c)(3)(B)) and is certified by the Secretary of the Interior to the Secretary of the Treasury as being of historic significance to the district.<sup>359</sup> For this purpose, a structure means any structure, whether or not it is depreciable, and, accordingly, easements on private residences may qualify.<sup>360</sup> If restrictions to preserve a building or land area within a registered historic district permit future development on the site, a deduction will be allowed only if the terms of the restrictions require that such development conform with appropriate local, State, or Federal standards for construction or rehabilitation within the district.<sup>361</sup>

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<sup>354</sup> Treas. Reg. sec. 1.170A-14(h)(3).

<sup>355</sup> Treas. Reg. sec. 1.170A-14(h)(3)(i).

<sup>356</sup> *Id.*

<sup>357</sup> *Id.*

<sup>358</sup> Treas. Reg. sec. 1.170A-14(h)(3)(ii).

<sup>359</sup> Sec. 170(h)(4)(B).

<sup>360</sup> Treas. Reg. sec. 1.170A-14(d)(5)(iii).

<sup>361</sup> Treas. Reg. sec. 1.170A-14(d)(5)(i).

The IRS and the courts have held that a facade easement may constitute a qualifying conservation contribution.<sup>362</sup> In general, a facade easement is a restriction the purpose of which is to preserve certain architectural, historic, and cultural features of the facade, or front, of a building. The terms of a facade easement might permit the property owner to make alterations to the facade of the structure if the owner obtains consent from the qualified organization that holds the easement.

### **Rehabilitation credit**

In general, present law allows as part of the general business credit an investment tax credit.<sup>363</sup> The amount of the investment tax credit includes the amount of a rehabilitation credit.<sup>364</sup> The rehabilitation credit for any taxable year is the sum of ten percent of the qualified rehabilitation expenditures with respect to any qualified rehabilitated building other than a certified historic structure and 20 percent of the qualified rehabilitation expenditures with respect to any certified historic structure.<sup>365</sup> In general, a qualified rehabilitated building is a depreciable building (and its structural components) if the building has been substantially rehabilitated, was placed in service before the beginning of the rehabilitation, and (except for a certified historic structure) in the rehabilitation process a certain percentage of the existing internal and external walls and internal structural framework are retained in place as internal and external walls and internal structural framework. A qualified rehabilitation expenditure is, in general, an amount properly chargeable to a capital account (i) for depreciable property that is nonresidential real property, residential rental property, real property that has a class life of more than 12.5 years, or an addition or improvement to any such property and (ii) in connection with the rehabilitation of a qualified rehabilitation building.

### **Explanation of Provision**

#### **Easements in registered historic districts**

The provision revises the rules for qualified conservation contributions with respect to property for which a charitable deduction is allowable under section 170(h)(4)(B)(ii) by reason of a property's location in a registered historic district. Under the provision, a charitable deduction is not allowable with respect to a structure or land area located in such a district (by reason of the structure or land area's location in such a district). A charitable deduction is

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<sup>362</sup> *Hillborn v. Commissioner*, 85 T.C. 677 (1985) (holding the fair market value of a facade donation generally is determined by applying the "before and after" valuation approach); *Richmond v. U.S.*, 699 F. Supp. 578 (E.D. La. 1988); Priv. Ltr. Rul. 199933029 (May 24, 1999) (ruling that a preservation and conservation easement relating to the facade and certain interior portions of a fraternity house was a qualified conservation contribution).

<sup>363</sup> Sec. 38(b)(1).

<sup>364</sup> Sec. 46.

<sup>365</sup> Sec. 47(a).

allowable with respect to buildings (as is the case under present law) but the qualified real property interest that relates to the exterior of the building must preserve the entire exterior of the building, including the space above the building, the sides, the rear, and the front of the building. In addition, such qualified real property interest must provide that no portion of the exterior of the building may be changed in a manner inconsistent with the historical character of such exterior.

For any contribution relating to a registered historic district made after the date of enactment of the provision, taxpayers must include with the return for the taxable year of the contribution a qualified appraisal of the qualified real property interest (irrespective of the claimed value of such interest) and attach the appraisal with the taxpayer's return, photographs of the entire exterior of the building,<sup>366</sup> and descriptions of all current restrictions on development of the building, including, for example, zoning laws, ordinances, neighborhood association rules, restrictive covenants, and other similar restrictions. Failure to obtain and attach an appraisal or to include the required information results in disallowance of the deduction. In addition, the donor and the donee must enter into a written agreement certifying, under penalty of perjury, that the donee is a qualified organization, with a purpose of environmental protection, land conservation, open space preservation, or historic preservation, and that the donee has the resources to manage and enforce the restriction and a commitment to do so.

Taxpayers claiming a deduction for a qualified conservation contribution with respect to the exterior of a building located in a registered historic district in excess of \$10,000 must pay a \$500 fee to the Internal Revenue Service or the deduction is not allowed. Amounts paid are required to be dedicated to Internal Revenue Service enforcement of qualified conservation contributions.

### **Reduction of deduction to take account of rehabilitation credit**

The provision provides that in the case of any qualified conservation contribution, the amount of the deduction is reduced by an amount that bears the same ratio to the fair market value of the contribution as the sum of the rehabilitation credits under section 47 for the preceding five taxable years with respect to a building that is part of the contribution bears to the fair market value of the building on the date of the contribution. For example, if a taxpayer makes a qualified conservation contribution with respect to a building, and such taxpayer has claimed a rehabilitation credit with respect to such building in any of the five taxable years preceding the year in which the contribution is claimed, the taxpayer must reduce the amount of the contribution. If the aggregate amount of credits claimed by the taxpayer within such five year period is \$100,000, and the fair market value of the building with respect to which the contribution is made is \$1,000,000, the taxpayer must reduce the amount of the deduction by 10 percent (or 100,000 over 1,000,000).

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<sup>366</sup> Photographs of the entire exterior of the building are required to the extent practicable. For example, if the building is a skyscraper, aerial photographs of the roof would not be required, but photographs sufficient to establish the existing exterior still must be submitted.

## Effective Date

The provisions relating to deductions for contributions relating to structures and land areas and to the rehabilitation credit are effective for contributions made after the date of enactment. The provision relating to a filing fee is effective for contributions made 180 days after the date of enactment. The rest of the provision is effective for contributions made after July 25, 2006.

### **4. Reform rules relating to charitable contributions of taxidermy (sec. 170 of the Code)**

#### Present Law

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and the fair market value of property contributed to an organization described in section 501(c)(3) or to a Federal, State, or local governmental entity.<sup>367</sup> The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced or limited depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.<sup>368</sup> In general, more generous charitable contribution deduction rules apply to gifts made to public charities than to gifts made to private foundations. Within certain limitations, donors also are entitled to deduct their contributions to section 501(c)(3) organizations for Federal estate and gift tax purposes. By contrast, contributions to nongovernmental, non-charitable tax-exempt organizations generally are not deductible by the donor,<sup>369</sup> though such organizations are eligible for the exemption from Federal income tax with respect to such donations.

The amount of the deduction for charitable contributions of capital gain property generally equals the fair market value of the contributed property on the date of the contribution. Capital gain property means any capital asset, or property used in the taxpayer's trade or business, the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property are subject to different percentage limitations (i.e., limitations based on the donor's income) than other contributions of property.

For certain contributions of property, the deductible amount is reduced from the fair market value of the contributed property by the amount of any gain, generally resulting in a

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<sup>367</sup> The deduction also is allowed for purposes of calculating alternative minimum taxable income.

<sup>368</sup> Secs. 170(b) and (e).

<sup>369</sup> Exceptions to the general rule of non-deductibility include certain gifts made to a veterans' organization or to a domestic fraternal society. In addition, contributions to certain nonprofit cemetery companies are deductible for Federal income tax purposes, but generally are not deductible for Federal estate and gift tax purposes. Secs. 170(c)(3), 170(c)(4), 170(c)(5), 2055(a)(3), 2055(a)(4), 2106(a)(2)(A)(iii), 2522(a)(3), and 2522(a)(4).

deduction equal to the taxpayer's basis. This rule applies to contributions of: (1) ordinary income property, e.g., property that, at the time of contribution, would not have resulted in long-term capital gain if the property was sold by the taxpayer on the contribution date;<sup>370</sup> (2) tangible personal property that is used by the donee in a manner unrelated to the donee's exempt (or governmental) purpose; and (3) property to or for the use of a private foundation (other than a foundation defined in section 170(b)(1)(E)).

Charitable contributions of taxidermy are subject to the tangible personal property rule (number (2) above). For example, for appreciated taxidermy, if the property is used to further the donee's exempt purpose, the deduction is fair market value. But if the property is not used to further the donee's exempt purpose, the deduction is the donor's basis. If the taxidermy is depreciated, i.e., the value is less than the taxpayer's basis in such property, taxpayers generally deduct the fair market value of such contributions, regardless of whether the property is used for exempt or unrelated purposes by the donee.

### **Explanation of Provision**

In general, the provision provides that the amount allowed as a deduction for charitable contributions of taxidermy property that is contributed by the person who prepared, stuffed, or mounted the property (or by any person who paid or incurred the cost of such preparation, stuffing, or mounting) is the lesser of the taxpayer's basis in the property or the fair market value of the property. Specifically, a taxpayer that makes such a charitable contribution of taxidermy property for a use related to the donee's exempt purpose or function must, in determining the amount of the deduction, reduce the fair market value of the property by the amount of gain that would have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value (determined at the time of the contribution). Taxidermy property is defined as any work of art that is the reproduction or preservation of an animal in whole or in part, is prepared, stuffed or mounted for purposes of recreating one or more characteristics of such animal, and contains a part of the body of the dead animal.

For purposes of determining a taxpayer's basis in taxidermy property that is contributed by the person who prepared, stuffed, or mounted the property (or by any person who paid or incurred the cost of such preparation, stuffing, or mounting), the provision provides a special rule that the basis of such property may include only the cost of the preparing, stuffing, or mounting. For purposes of the special rule, it is intended that only the direct costs of the preparing, stuffing, or mounting may be included in basis. Indirect costs, not included in the basis, include the costs of transportation relating to any aspect of the taxidermy or the hunting of the animal, and the direct or indirect costs relating to the hunting or killing of an animal (including the cost of equipment and the costs of preparing an animal carcass for taxidermy).

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<sup>370</sup> For certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one half of fair market value in excess of basis) or (2) two times basis. Sec. 170(e)(3), 170(e)(4), 170(e)(6).

## Effective Date

The provision is effective for contributions made after July 25, 2006.

### **5. Recapture of tax benefit on property not used for an exempt use (new sec. 6720B of the Code)**

## Present Law

### Deductibility of charitable contributions

#### In general

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and the fair market value of property contributed to an organization described in section 501(c)(3) or to a Federal, State, or local governmental entity.<sup>371</sup> The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced or limited depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.<sup>372</sup> In general, more generous charitable contribution deduction rules apply to gifts made to public charities than to gifts made to private foundations. Within certain limitations, donors also are entitled to deduct their contributions to section 501(c)(3) organizations for Federal estate and gift tax purposes. By contrast, contributions to nongovernmental, non-charitable tax-exempt organizations generally are not deductible by the donor,<sup>373</sup> though such organizations are eligible for the exemption from Federal income tax with respect to such donations.

#### Contributions of property

The amount of the deduction for charitable contributions of capital gain property generally equals the fair market value of the contributed property on the date of the contribution. Capital gain property means any capital asset, or property used in the taxpayer's trade or business, the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property are subject to different percentage limitations (i.e., limitations based on the donor's income) than other contributions of property.

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<sup>371</sup> The deduction also is allowed for purposes of calculating alternative minimum taxable income.

<sup>372</sup> Secs. 170(b) and (e).

<sup>373</sup> Exceptions to the general rule of non-deductibility include certain gifts made to a veterans' organization or to a domestic fraternal society. In addition, contributions to certain nonprofit cemetery companies are deductible for Federal income tax purposes, but generally are not deductible for Federal estate and gift tax purposes. Secs. 170(c)(3), 170(c)(4), 170(c)(5), 2055(a)(3), 2055(a)(4), 2106(a)(2)(A)(iii), 2522(a)(3), and 2522(a)(4).

For certain contributions of property, the deductible amount is reduced from the fair market value of the contributed property by the amount of any gain, generally resulting in a deduction equal to the taxpayer's basis. This rule applies to contributions of: (1) ordinary income property, e.g., property that, at the time of contribution, would not have resulted in long-term capital gain if the property was sold by the taxpayer on the contribution date;<sup>374</sup> (2) tangible personal property that is used by the donee in a manner unrelated to the donee's exempt (or governmental) purpose; and (3) property to or for the use of a private foundation (other than a foundation defined in section 170(b)(1)(E)).

### Substantiation

No charitable deduction is allowed for any contribution of \$250 or more unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgement of the contribution by the donee organization.<sup>375</sup> Such acknowledgement must include the amount of cash and a description (but not value) of any property other than cash contributed, whether the donee provided any goods or services in consideration for the contribution (and a good faith estimate of the value of any such goods or services).

In general, if the total charitable deduction claimed for non-cash property is more than \$500, the taxpayer must attach a completed Form 8283 (Noncash Charitable Contributions) to the taxpayer's return or the deduction is not allowed.<sup>376</sup> C corporations (other than personal service corporations and closely-held corporations) are required to file Form 8283 only if the deduction claimed is more than \$5,000. Information required on the Form 8283 includes, among other things, a description of the property, the appraised fair market value (if an appraisal is required), the donor's basis in the property, how the donor acquired the property, a declaration by the appraiser regarding the appraiser's general qualifications, an acknowledgement by the donee that it is eligible to receive deductible contributions, and an indication by the donee whether the property is intended for an unrelated use.

Taxpayers are required to obtain a qualified appraisal for donated property with a value of more than \$5,000, and to attach an appraisal summary to the tax return.<sup>377</sup> Under Treasury regulations, a qualified appraisal means an appraisal document that, among other things: (1) relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property and not later than the due date (including extensions) of the return on which a

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<sup>374</sup> For certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one half of fair market value in excess of basis) or (2) two times basis. Sec. 170(e)(3), 170(e)(4), 170(e)(6).

<sup>375</sup> Sec. 170(f)(8).

<sup>376</sup> Sec. 170(f)(11).

<sup>377</sup> *Id.*

deduction is first claimed under section 170,<sup>378</sup> (2) is prepared, signed, and dated by a qualified appraiser; (3) includes (a) a description of the property appraised; (b) the fair market value of such property on the date of contribution and the specific basis for the valuation; (c) a statement that such appraisal was prepared for income tax purposes; (d) the qualifications of the qualified appraiser; and (e) the signature and taxpayer identification number of such appraiser; and (4) does not involve an appraisal fee that violates certain prescribed rules.<sup>379</sup> In the case of contributions of art valued at more than \$20,000 and other contributions of more than \$500,000, taxpayers are required to attach the appraisal to the tax return. Taxpayers may request a Statement of Value from the Internal Revenue Service in order to substantiate the value of art with an appraised value of \$50,000 or more for income, estate, or gift tax purposes.<sup>380</sup> The fee for such a Statement is \$2,500 for one, two, or three items or art plus \$250 for each additional item.

If a donee organization sells, exchanges, or otherwise disposes of contributed property with a claimed value of more than \$5,000 (other than publicly traded securities) within two years of the property's receipt, the donee is required to file a return (Form 8282) with the Secretary, and to furnish a copy of the return to the donor, showing the name, address, and taxpayer identification number of the donor, a description of the property, the date of the contribution, the amount received on the disposition, and the date of the disposition.<sup>381</sup>

### **Explanation of Provision**

In general, the provision recovers the tax benefit for charitable contributions of tangible personal property with respect to which a fair market value deduction is claimed and which is not used for exempt purposes. The provision applies to appreciated tangible personal property that is identified by the donee organization, for example on the Form 8283, as for a use related to the purpose or function constituting the donee's basis for tax exemption, and for which a deduction of more than \$5,000 is claimed ("applicable property").<sup>382</sup>

Under the provision, if a donee organization disposes of applicable property within three years of the contribution of the property, the donor is subject to an adjustment of the tax benefit. If the disposition occurs in the tax year of the donor in which the contribution is made, the donor's deduction generally is basis and not fair market value.<sup>383</sup> If the disposition occurs in a

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<sup>378</sup> In the case of a deduction first claimed or reported on an amended return, the deadline is the date on which the amended return is filed.

<sup>379</sup> Treas. Reg. sec. 1.170A-13(c)(3). Sec. 170(f)(11)(E).

<sup>380</sup> Rev. Proc. 96-15, 1996-1 C.B. 627.

<sup>381</sup> Sec. 6050L(a)(1).

<sup>382</sup> Present law rules continue to apply to any contribution of exempt use property for which a deduction of \$5,000 or less is claimed.

<sup>383</sup> The disposition proceeds are regarded as relevant to a determination of fair market value.

subsequent year, the donor must include as ordinary income for its taxable year in which the disposition occurs an amount equal to the excess (if any) of (i) the amount of the deduction previously claimed by the donor as a charitable contribution with respect to such property, over (ii) the donor's basis in such property at the time of the contribution.

There is no adjustment of the tax benefit if the donee organization makes a certification to the Secretary, by written statement signed under penalties of perjury by an officer of the organization. The statement must either (1) certify that the use of the property by the donee was related to the purpose or function constituting the basis for the donee's exemption, and describe how the property was used and how such use furthered such purpose or function; or (2) state the intended use of the property by the donee at the time of the contribution and certify that such use became impossible or infeasible to implement. The organization must furnish a copy of the certification to the donor (for example, as part of the Form 8282, a copy of which is supplied to the donor).

A penalty of \$10,000 applies to a person that identifies applicable property as having a use that is related to a purpose or function constituting the basis for the donee's exemption knowing that it is not intended for such a use.<sup>384</sup>

### **Reporting of exempt use property contributions**

The provision modifies the present-law information return requirements that apply upon the disposition of contributed property by a charitable organization (Form 8282, sec. 6050L). The return requirement is extended to dispositions made within three years after receipt (from two years). The donee organization also must provide, in addition to the information already required to be provided on the return, a description of the donee's use of the property, a statement of whether use of the property was related to the purpose or function constituting the basis for the donee's exemption, and, if applicable, a certification of any such use (described above).

### **Effective Date**

The provision is effective for contributions made and returns filed after September 1, 2006, and with respect to the penalty, for identifications made after the date of enactment.

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<sup>384</sup> Other present-law penalties also may apply, such as the penalty for aiding and abetting the understatement of tax liability under section 6701.

## **6. Limit charitable deduction for contributions of clothing and household items (sec. 170 of the Code)**

### **Present Law**

#### **In general**

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and the fair market value of property contributed to an organization described in section 501(c)(3) or to a Federal, State, or local governmental entity.<sup>385</sup> The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced or limited depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.<sup>386</sup> In general, more generous charitable contribution deduction rules apply to gifts made to public charities than to gifts made to private foundations. Within certain limitations, donors also are entitled to deduct their contributions to section 501(c)(3) organizations for Federal estate and gift tax purposes. By contrast, contributions to nongovernmental, non-charitable tax-exempt organizations generally are not deductible by the donor,<sup>387</sup> though such organizations are eligible for the exemption from Federal income tax with respect to such donations.

#### **Contributions of property**

The amount of the deduction for charitable contributions of capital gain property generally equals the fair market value of the contributed property on the date of the contribution. Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property are subject to different percentage limitations than other contributions of property.

For certain contributions of property, the deductible amount is reduced from the fair market value of the contributed property by the amount of any gain, generally resulting in a deduction equal to the taxpayer's basis. This rule applies to contributions of: (1) ordinary income property, e.g., property that, at the time of contribution, would not have resulted in long-

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<sup>385</sup> The deduction also is allowed for purposes of calculating alternative minimum taxable income.

<sup>386</sup> Secs. 170(b) and (e).

<sup>387</sup> Exceptions to the general rule of non-deductibility include certain gifts made to a veterans' organization or to a domestic fraternal society. In addition, contributions to certain nonprofit cemetery companies are deductible for Federal income tax purposes, but generally are not deductible for Federal estate and gift tax purposes. Secs. 170(c)(3), 170(c)(4), 170(c)(5), 2055(a)(3), 2055(a)(4), 2106(a)(2)(A)(iii), 2522(a)(3), and 2522(a)(4).

term capital gain if the property was sold by the taxpayer on the contribution date;<sup>388</sup> (2) tangible personal property that is used by the donee in a manner unrelated to the donee's exempt (or governmental) purpose; and (3) property to or for the use of a private foundation (other than a foundation defined in section 170(b)(1)(E)).

Charitable contributions of clothing and household items are subject to the tangible personal property rule (number (2) above). If such contributed property is appreciated property in the hands of the taxpayer, and is not used to further the donee's exempt purpose, the deduction is basis. In general, however, the value of clothing and household items is less than the taxpayer's basis in such property, with the result that taxpayers generally deduct the fair market value of such contributions, regardless of whether the property is used for exempt or unrelated purposes by the donee.

### **Substantiation**

A donor who claims a deduction for a charitable contribution must maintain reliable written records regarding the contribution, regardless of the value or amount of such contribution. For a contribution of money, the donor generally must maintain one of the following: (1) a cancelled check; (2) a receipt (or a letter or other written communication) from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution; or (3) in the absence of a cancelled check or a receipt, other reliable written records showing the name of the donee, the date of the contribution, and the amount of the contribution. For a contribution of property other than money, the donor generally must maintain a receipt from the donee organization showing the name of the donee, the date and location of the contribution, and a detailed description (but not the value) of the property.<sup>389</sup> A donor of property other than money need not obtain a receipt, however, if circumstances make obtaining a receipt impracticable. Under such circumstances, the donor must maintain reliable written records regarding the contribution. The required content of such a record varies depending upon factors such as the type and value of property contributed.<sup>390</sup>

In addition to the foregoing recordkeeping requirements, substantiation requirements apply in the case of charitable contributions with a value of \$250 or more. No charitable deduction is allowed for any contribution of \$250 or more unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgement of the contribution by the donee organization. Such acknowledgement must include the amount of cash and a description (but not value) of any property other than cash contributed, whether the donee provided any goods or services in consideration for the contribution, and a good faith estimate of the value of any such

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<sup>388</sup> For certain contributions of inventory and other property, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one half of fair market value in excess of basis) or (2) two times basis. Sec. 170(e)(3), 170(e)(4), 170(e)(6).

<sup>389</sup> Treas. Reg. sec. 1.170A-13(a).

<sup>390</sup> Treas. Reg. sec. 1.170A-13(b).

goods or services.<sup>391</sup> In general, if the total charitable deduction claimed for non-cash property is more than \$500, the taxpayer must attach a completed Form 8283 (Noncash Charitable Contributions) to the taxpayer's return or the deduction is not allowed.<sup>392</sup> In general, taxpayers are required to obtain a qualified appraisal for donated property with a value of more than \$5,000, and to attach an appraisal summary to the tax return.

### **Explanation of Provision**

The provision provides that no deduction is allowed for a charitable contribution of clothing or household items unless the clothing or household item is in good used condition or better. The Secretary is authorized to deny by regulation a deduction for any contribution of clothing or a household item that has minimal monetary value, such as used socks and used undergarments. It is noted that the President's Advisory Panel on Federal Tax Reform and the staff of the Joint Committee on Taxation both have concluded that the fair market value-based deduction for contributions of clothing and household items present difficult tax administration issues, as determining the correct value of an item is a fact intensive, and thus also a resource intensive matter.<sup>393</sup> As recently reported by the IRS, the amount claimed as deductions in tax year 2003 for clothing and household items was more than \$9 billion.<sup>394</sup> It is expected that the Secretary, in consultation with affected charities, will exercise assiduously the authority to disallow a deduction for some items of low value, consistent with the goals of improving tax administration and ensure that donated clothing and household items are of meaningful use to charitable organizations.

Under the provision, a deduction may be allowed for a charitable contribution of an item of clothing or a household item not in good used condition or better if the amount claimed for the item is more than \$500 and the taxpayer includes with the taxpayer's return a qualified appraisal with respect to the property. Household items include furniture, furnishings, electronics, appliances, linens, and other similar items. Food, paintings, antiques, and other objects of art, jewelry and gems, and collections are excluded from the provision.

### **Effective Date**

The provision is effective for contributions made after the date of enactment.

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<sup>391</sup> Sec. 170(f)(8).

<sup>392</sup> Sec. 170(f)(11).

<sup>393</sup> See *The President's Advisory Panel on Federal Tax Reform*, 78 (2005); Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* 288 (JCS-02-05), January 27, 2005.

<sup>394</sup> Internal Revenue Service, Statistics of Income Division, *Individual Noncash Charitable Contributions, 2003*, Figure A (Spring 2006).

## **7. Modify recordkeeping and substantiation requirements for certain charitable contributions (sec. 170 of the Code)**

### **Present Law**

A donor who claims a deduction for a charitable contribution must maintain reliable written records regarding the contribution, regardless of the value or amount of such contribution. For a contribution of money, the donor generally must maintain one of the following: (1) a cancelled check; (2) a receipt (or a letter or other written communication) from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution; or (3) in the absence of a cancelled check or a receipt, other reliable written records showing the name of the donee, the date of the contribution, and the amount of the contribution. For a contribution of property other than money, the donor generally must maintain a receipt from the donee organization showing the name of the donee, the date and location of the contribution, and a detailed description (but not the value) of the property.<sup>395</sup> A donor of property other than money need not obtain a receipt, however, if circumstances make obtaining a receipt impracticable. Under such circumstances, the donor must maintain reliable written records regarding the contribution. The required content of such a record varies depending upon factors such as the type and value of property contributed.<sup>396</sup>

In addition to the foregoing recordkeeping requirements, substantiation requirements apply in the case of charitable contributions with a value of \$250 or more. No charitable deduction is allowed for any contribution of \$250 or more unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgement of the contribution by the donee organization. Such acknowledgement must include the amount of cash and a description (but not value) of any property other than cash contributed, whether the donee provided any goods or services in consideration for the contribution, and a good faith estimate of the value of any such goods or services.<sup>397</sup> In general, if the total charitable deduction claimed for non-cash property is more than \$500, the taxpayer must attach a completed Form 8283 (Noncash Charitable Contributions) to the taxpayer's return or the deduction is not allowed.<sup>398</sup> In general, taxpayers are required to obtain a qualified appraisal for donated property with a value of more than \$5,000, and to attach an appraisal summary to the tax return.

### **Explanation of Provision**

The provision more closely aligns the substantiation rules for money to the substantiation rules for property by providing that in the case of a charitable contribution of money, regardless of the amount, applicable recordkeeping requirements are satisfied only if the donor maintains as

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<sup>395</sup> Treas. Reg. sec. 1.170A-13(a).

<sup>396</sup> Treas. Reg. sec. 1.170A-13(b).

<sup>397</sup> Sec. 170(f)(8).

<sup>398</sup> Sec. 170(f)(11).

a record of the contribution a bank record or a written communication from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution. The recordkeeping requirements may not be satisfied by maintaining other written records. It is noted that currently, taxpayers are required to have a contemporaneous record of contributions of money, but that many taxpayers may not be aware of the requirement and do not keep a log of such contributions. The provision is intended to provide greater certainty, both to taxpayers and to the Secretary, in determining what may be deducted as a charitable contribution.

### **Effective Date**

The provision is effective for contributions made in taxable years beginning after the date of enactment.

## **8. Contributions of fractional interests in tangible personal property (secs. 170, 2055, and 2522 of the Code)**

### **Present Law**

In general, a charitable deduction is not allowable for a contribution of a partial interest in property, such as an income interest, a remainder interest, or a right to use property.<sup>399</sup> A gift of an undivided portion of a donor's entire interest in property generally is not treated as a nondeductible gift of a partial interest in property.<sup>400</sup> For this purpose, an undivided portion of a donor's entire interest in property must consist of a fraction or percentage of each and every substantial interest or right owned by the donor in such property and must extend over the entire term of the donor's interest in such property.<sup>401</sup> A gift generally is treated as a gift of an undivided portion of a donor's entire interest in property if the donee is given the right, as a tenant in common with the donor, to possession, dominion, and control of the property for a portion of each year appropriate to its interest in such property.<sup>402</sup>

A charitable contribution deduction generally is not allowable for a contribution of a future interest in tangible personal property.<sup>403</sup> For this purpose, a future interest is one "in which a donor purports to give tangible personal property to a charitable organization, but has an understanding, arrangement, agreement, etc., whether written or oral, with the charitable organization which has the effect of reserving to, or retaining in, such donor a right to the use, possession, or enjoyment of the property."<sup>404</sup> Treasury regulations provide that section

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<sup>399</sup> Secs. 170(f)(3)(A) (income tax), 2055(e)(2) (estate tax), and 2522(c)(2) (gift tax).

<sup>400</sup> Sec. 170(f)(3)(B)(ii).

<sup>401</sup> Treas. Reg. sec. 1.170A-7(b)(1).

<sup>402</sup> Treas. Reg. sec. 1.170A-7(b)(1).

<sup>403</sup> Sec. 170(a)(3).

<sup>404</sup> Treas. Reg. sec. 1.170A-5(a)(4).

170(a)(3), which generally denies a deduction for a contribution of a future interest in tangible personal property, “[has] no application in respect of a transfer of an undivided present interest in property. For example, a contribution of an undivided one-quarter interest in a painting with respect to which the donee is entitled to possession during three months of each year shall be treated as made upon the receipt by the donee of a formally executed and acknowledged deed of gift. However, the period of initial possession by the donee may not be deferred in time for more than one year.”<sup>405</sup>

### **Explanation of Provision**

In general, under present law and the provision a donor may take a deduction for a charitable contribution of a fractional interest in tangible personal property (such as an artwork), provided the donor satisfies the requirements for deductibility (including the requirements concerning contributions of partial interests and future interests in property), and in subsequent years make additional charitable contributions of interests in the same property.<sup>406</sup> Under the provision, the value of a donor’s charitable deduction for the initial contribution of a fractional interest in an item of tangible personal property (or collection of such items) shall be determined as under current law (e.g., based upon the fair market value of the artwork at the time of the contribution of the fractional interest and considering whether the use of the artwork will be related to the donee’s exempt purposes). For purposes of determining the deductible amount of each additional contribution of an interest (whether or not a fractional interest) in the same item of property, the fair market value of the item is the lesser of: (1) the value used for purposes of determining the charitable deduction for the initial fractional contribution; or (2) the fair market value of the item at the time of the subsequent contribution. This portion of the provision applies for income, gift, and estate tax purposes.

The provision provides for recapture of the income tax charitable deduction and gift tax charitable deduction under certain circumstances. First, if a donor makes an initial fractional contribution, then fails to contribute all of the donor’s remaining interest in such property to the same donee before the earlier of 10 years from the initial fractional contribution or the donor’s death, then the donee’s charitable income and gift tax deductions for all previous contributions of interests in the item shall be recaptured (plus interest). If the donee of the initial contribution is no longer in existence as of such time, the donor’s remaining interest may be contributed to another organization described in section 170(c) (which describes organizations to which contributions that are deductible for income tax purposes may be made). Second, if the donee of a fractional interest in an item of tangible personal property fails to take substantial physical possession of the item during the period described above (the possession requirement) or fails to use the property for an exempt use during the period described above (the related-use requirement), then the donee’s charitable income and gift tax deductions for all previous contributions of interests in the item shall be recaptured (plus interest). If, for example, an art museum described in section 501(c)(3) that is the donee of a fractional interest in a painting

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<sup>405</sup> Treas. Reg. sec. 1.170A-5(a)(2).

<sup>406</sup> See, e.g., *Winokur v. Commissioner*, 90 T.C. 733 (1988).

includes the painting in an art exhibit sponsored by the museum, such use generally will be treated as satisfying the related-use requirement of the provision.

In any case in which there is a recapture of a deduction as described in the preceding paragraph, the provision also imposes an additional tax in an amount equal to 10 percent of the amount recaptured.

Under the provision, no income or gift tax charitable deduction is allowed for a contribution of a fractional interest in an item of tangible personal property unless immediately before such contribution all interests in the item are owned (1) by the donor or (2) by the donor and the donee organization. The Secretary is authorized to make exceptions to this rule in cases where all persons who hold an interest in the item make proportional contributions of undivided interests in their respective shares of such item to the donee organization. For example, if A owns an undivided 40 percent interest in a painting and B owns an undivided 60 percent interest in the same painting, the Secretary may provide that A may take a deduction for a charitable contribution of less than the entire interest held by A, provided that both A and B make proportional contributions of undivided fractional interests in their respective shares of the painting to the same donee organization (e.g., if A contributes 50 percent of A's interest and B contributes 50 percent of B's interest).

It is intended that a contribution occurring before the date of enactment not be treated as an initial fractional contribution for purposes of the provision. Instead, the first fractional contribution by a taxpayer after the date of enactment would be considered the initial fractional contribution under the provision, regardless of whether the taxpayer had made a contribution of a fractional interest in the same item of tangible personal property prior to the date of enactment.

### **Effective Date**

The provision is applicable for contributions, bequests, and gifts made after the date of enactment.

## **9. Proposals relating to appraisers and substantial and gross overstatement of valuations of property (secs. 170, 6662, 6664, 6696 and new sec. 6695A of the Code)**

### **Present Law**

#### **Taxpayer penalties**

Present law imposes accuracy-related penalties on a taxpayer in cases involving a substantial valuation misstatement or gross valuation misstatement relating to an underpayment of income tax.<sup>407</sup> For this purpose, a substantial valuation misstatement generally means a value claimed that is at least twice (200 percent or more) the amount determined to be the correct value, and a gross valuation misstatement generally means a value claimed that is at least four times (400 percent or more) the amount determined to be the correct value.

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<sup>407</sup> Sec. 6662(b)(3) and (h).

The penalty is 20 percent of the underpayment of tax resulting from a substantial valuation misstatement and rises to 40 percent for a gross valuation misstatement. No penalty is imposed unless the portion of the underpayment attributable to the valuation misstatement exceeds \$5,000 (\$10,000 in the case of a corporation other than an S corporation or a personal holding company). Under present law, no penalty is imposed with respect to any portion of the understatement attributable to any item if (1) the treatment of the item on the return is or was supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed on the return or on a statement attached to the return and there is a reasonable basis for the tax treatment. Special rules apply to tax shelters.

Present law also imposes an accuracy-related penalty on substantial or gross estate or gift tax valuation understatements.<sup>408</sup> In general, there is a substantial estate or gift tax understatement if the value of any property claimed on any return is 50 percent or less of the amount determined to be the correct amount, and a gross estate or gift tax understatement if such value is 25 percent or less of the amount determined to be the correct amount.

In addition, the accuracy-related penalties do not apply if a taxpayer shows there was reasonable cause for an underpayment and the taxpayer acted in good faith.<sup>409</sup>

### **Penalty for aiding and abetting understatement of tax**

A penalty is imposed on a person who: (1) aids or assists in or advises with respect to a tax return or other document; (2) knows (or has reason to believe) that such document will be used in connection with a material tax matter; and (3) knows that this would result in an understatement of tax of another person. In general, the amount of the penalty is \$1,000. If the document relates to the tax return of a corporation, the amount of the penalty is \$10,000.

### **Qualified appraisals**

Present law requires a taxpayer to obtain a qualified appraisal for donated property with a value of more than \$5,000, and to attach an appraisal summary to the tax return.<sup>410</sup> Treasury Regulations state that a qualified appraisal means an appraisal document that, among other things: (1) relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property and not later than the due date (including extensions) of the return on which a deduction is first claimed under section 170; (2) is prepared, signed, and dated by a qualified appraiser; (3) includes (a) a description of the property appraised; (b) the fair market value of such property on the date of contribution and the specific basis for the valuation; (c) a statement that such appraisal was prepared for income tax purposes; (d) the qualifications of

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<sup>408</sup> Sec. 6662(g) and (h).

<sup>409</sup> Sec. 6664(c).

<sup>410</sup> Sec. 170(f)(11).

the qualified appraiser; and (e) the signature and taxpayer identification number of such appraiser; and (4) does not involve an appraisal fee that violates certain prescribed rules.<sup>411</sup>

### **Qualified appraisers**

Treasury Regulations define a qualified appraiser as a person who holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis, is qualified to make appraisals of the type of property being valued (as determined by the appraiser's background, experience, education and membership, if any, in professional appraisal associations), is independent, and understands that an intentionally false or fraudulent overstatement of the value of the appraised property may subject the appraiser to civil penalties.<sup>412</sup>

### **Appraiser oversight**

The Secretary is authorized to regulate the practice of representatives of persons before the Department of the Treasury ("Department").<sup>413</sup> After notice and hearing, the Secretary is authorized to suspend or disbar from practice before the Department or the Internal Revenue Service ("IRS") a representative who is incompetent, who is disreputable, who violates the rules regulating practice before the Department or the IRS, or who (with intent to defraud) willfully and knowingly misleads or threatens the person being represented (or a person who may be represented).

The Secretary also is authorized to bar from appearing before the Department or the IRS, for the purpose of offering opinion evidence on the value of property or other assets, any individual against whom a civil penalty for aiding and abetting the understatement of tax has been assessed. Thus, an appraiser who aids or assists in the preparation or presentation of an appraisal will be subject to disciplinary action if the appraiser knows that the appraisal will be used in connection with the tax laws and will result in an understatement of the tax liability of another person. The Secretary has authority to provide that the appraisals of an appraiser who has been disciplined have no probative effect in any administrative proceeding before the Department or the IRS.

## **Explanation of Provision**

### **Taxpayer penalties**

The provision lowers the thresholds for imposing accuracy-related penalties on a taxpayer. Under the provision, a substantial valuation misstatement exists when the claimed value of any property is 150 percent or more of the amount determined to be the correct value. A

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<sup>411</sup> Treas. Reg. sec. 1.170A-13(c)(3).

<sup>412</sup> Treas. Reg. sec. 1.170A-13(c)(5)(i).

<sup>413</sup> 31 U.S.C. sec. 330.

gross valuation misstatement occurs when the claimed value of any property is 200 percent or more of the amount determined to be the correct value.

The provision tightens the thresholds for imposing accuracy-related penalties with respect to the estate or gift tax. Under the provision, a substantial estate or gift tax valuation misstatement exists when the claimed value of any property is 65 percent or less of the amount determined to be the correct value. A gross estate or gift tax valuation misstatement exists when the claimed value of any property is 40 percent or less of the amount determined to be the correct value.

Under the provision, the reasonable cause exception to the accuracy-related penalty does not apply in the case of gross valuation misstatements.

### **Appraiser oversight**

#### Appraiser penalties

The provision establishes a civil penalty on any person who prepares an appraisal that is to be used to support a tax position if such appraisal results in a substantial or gross valuation misstatement. The penalty is equal to the greater of \$1,000 or 10 percent of the understatement of tax resulting from a substantial or gross valuation misstatement, up to a maximum of 125 percent of the gross income derived from the appraisal. Under the provision, the penalty does not apply if the appraiser establishes that it was “more likely than not” that the appraisal was correct.

#### Disciplinary proceeding

The provision eliminates the requirement that the Secretary assess against an appraiser the civil penalty for aiding and abetting the understatement of tax before such appraiser may be subject to disciplinary action. Thus, the Secretary is authorized to discipline appraisers after notice and hearing. Disciplinary action may include, but is not limited to, suspending or barring an appraiser from: preparing or presenting appraisals on the value of property or other assets to the Department or the IRS; appearing before the Department or the IRS for the purpose of offering opinion evidence on the value of property or other assets; and providing that the appraisals of an appraiser who has been disciplined have no probative effect in any administrative proceeding before the Department or the IRS.

#### Qualified appraisers

The provision defines a qualified appraiser as an individual who (1) has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements to be determined by the IRS in regulations; (2) regularly performs appraisals for which he or she receives compensation; (3) can demonstrate verifiable education and experience in valuing the type of property for which the appraisal is being performed; (4) has not been prohibited from practicing before the IRS by the Secretary at any time during the three years preceding the conduct of the appraisal; and (5) is not excluded from being a qualified appraiser under applicable Treasury regulations.

### Qualified appraisals

The provision defines a qualified appraisal as an appraisal of property prepared by a qualified appraiser (as defined by the provision) in accordance with generally accepted appraisal standards and any regulations or other guidance prescribed by the Secretary.

### Effective Date

The provision amending the accuracy-related penalty applies to returns filed after the date of enactment. The provision establishing a civil penalty that may be imposed on any person who prepares an appraisal that is to be used to support a tax position if such appraisal results in a substantial or gross valuation misstatement applies to appraisals prepared with respect to returns or submissions filed after the date of enactment. The provisions relating to appraiser oversight apply to appraisals prepared with respect to returns or submissions filed after the date of enactment. With respect to any contribution of a qualified real property interest which is a restriction with respect to the exterior of a building described in section 170(h)(4)(C)(ii) (currently designated section 170(h)(4)(B)(ii), relating to certain property located in a registered historic district and certified as being of historic significance to the district), and any appraisal with respect to such contribution, the provision generally applies to returns filed after July 25, 2006.

## **10. Establish additional exemption standards for credit counseling organizations (secs. 501 and 513 of the Code)**

### Present Law

Under present law, a credit counseling organization may be exempt as a charitable or educational organization described in section 501(c)(3), or as a social welfare organization described in section 501(c)(4). The IRS has issued two revenue rulings holding that certain credit counseling organizations are exempt as charitable or educational organizations or as social welfare organizations.

In Revenue Ruling 65-299,<sup>414</sup> an organization whose purpose was to assist families and individuals with financial problems, and help reduce the incidence of personal bankruptcy, was determined to be a social welfare organization described in section 501(c)(4). The organization counseled people in financial difficulties, advised applicants on payment of debts, and negotiated with creditors and set up debt repayment plans. The organization did not restrict its services to the poor, made no charge for counseling services, and made a nominal charge for certain services to cover postage and supplies. For financial support, the organization relied on voluntary contributions from local businesses, lending agencies, and labor unions.

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<sup>414</sup> Rev. Rul. 65-299, 1965-2 C.B. 165.

In Revenue Ruling 69-441,<sup>415</sup> the IRS ruled an organization was a charitable or educational organization exempt under section 501(c)(3) by virtue of aiding low-income people who had financial problems and providing education to the public. The organization in that ruling had two functions: (1) educating the public on personal money management, such as budgeting, buying practices, and the sound use of consumer credit through the use of films, speakers, and publications; and (2) providing individual counseling to low-income individuals and families without charge. As part of its counseling activities, the organization established debt management plans for clients who required such services, at no charge to the clients.<sup>416</sup> The organization was supported by contributions primarily from creditors, and its board of directors was comprised of representatives from religious organizations, civic groups, labor unions, business groups, and educational institutions.

In 1976, the IRS denied exempt status to an organization, Consumer Credit Counseling Service of Alabama, whose activities were distinguishable from those in Revenue Ruling 69-441 in that (1) it did not restrict its services to the poor, and (2) it charged a nominal fee for its debt management plans.<sup>417</sup> The organization provided free information to the general public through the use of speakers, films, and publications on the subjects of budgeting, buying practices, and the use of consumer credit. It also provided counseling to debt-distressed individuals, not necessarily poor or low-income, and provided debt management plans at the cost of \$10 per month, which was waived in cases of financial hardship. Its debt management activities were a relatively small part of its overall activities. The district court determined the organization qualified as charitable and educational within section 501(c)(3), finding the debt management plans to be an integral part of the agency's counseling function, and that its debt management activities were incidental to its principal functions, as only approximately 12 percent of the counselors' time was applied to such programs and the charge for the service was nominal. The court also considered the facts that the agency was publicly supported, and that it had a board dominated by members of the general public, as factors indicating a charitable operation.<sup>418</sup>

A recent estimate shows the number of credit counseling organizations increased from approximately 200 in 1990 to over 1,000 in 2002.<sup>419</sup> During the period from 1994 to late 2003,

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<sup>415</sup> Rev. Rul. 69-441, 1969-2 C.B. 115.

<sup>416</sup> Debt management plans are debt payment arrangements, including debt consolidation arrangements, entered into by a debtor and one or more of the debtor's creditors, generally structured to reduce the amount of a debtor's regular ongoing payment by modifying the interest rate, minimum payment, maturity or other terms of the debt. Such plans frequently are promoted as a means for a debtor to restructure debt without filing for bankruptcy.

<sup>417</sup> *Consumer Credit Counseling Service of Alabama, Inc. v. U.S.*, 44 A.F.T.R. 2d (RIA) 5122 (D.D.C. 1978). The case involved 24 agencies throughout the United States.

<sup>418</sup> *See also, Credit Counseling Centers of Oklahoma, Inc., v. U.S.*, 45 A.F.T.R. 2d (RIA) 1401 (D.D.C. 1979) (holding the same on virtually identical facts).

<sup>419</sup> Opening Statement of The Honorable Max Sandlin, Hearing on Non-Profit Credit Counseling Organizations, House Ways and Means Committee, Subcommittee on Oversight (November 20, 2003).

1,215 credit counseling organizations applied to the IRS for tax exempt status under section 501(c)(3), including 810 during 2000 to 2003.<sup>420</sup> The IRS has recognized more than 850 credit counseling organizations as tax exempt under section 501(c)(3).<sup>421</sup> Few credit counseling organizations have sought section 501(c)(4) status, and the IRS reports it has not seen any significant increase in the number or activity of such organizations operating as social welfare organizations.<sup>422</sup> As of late 2003, there were 872 active tax-exempt credit counseling agencies operating in the United States.<sup>423</sup>

A credit counseling organization described in section 501(c)(3) is exempt from certain Federal and State consumer protection laws that provide exemptions for organizations described therein.<sup>424</sup> Some believe that these exclusions from Federal and State regulation may be a primary motivation for the recent increase in the number of organizations seeking and obtaining exempt status under section 501(c)(3).<sup>425</sup> Such regulatory exemptions generally are not available for social welfare organizations described in section 501(c)(4).

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<sup>420</sup> United States Senate Permanent Subcommittee on Investigations, Committee on Governmental Affairs, *Profiteering in a Non-Profit Industry: Abusive Practices in Credit Counseling*, Report Prepared by the Majority & Minority Staffs of the Permanent Subcommittee on Investigations and Released in Conjunction with the Permanent Subcommittee Investigations' Hearing on March 24, 2004, p. 3 (citing letter dated December 18, 2003, to the Subcommittee from IRS Commissioner Everson).

<sup>421</sup> Testimony of Commissioner Mark Everson before the House Ways and Means Committee, Subcommittee on Oversight (November 20, 2003).

<sup>422</sup> Testimony of Commissioner Mark Everson before the House Ways and Means Committee, Subcommittee on Oversight (November 20, 2003).

<sup>423</sup> United States Senate Permanent Subcommittee on Investigations, Committee on Governmental Affairs, *Profiteering in a Non-Profit Industry: Abusive Practices in Credit Counseling*, Report Prepared by the Majority & Minority Staffs of the Permanent Subcommittee on Investigations and Released in Conjunction with the Permanent Subcommittee Investigations' Hearing on March 24, 2004, p. 3 (citing letter dated December 18, 2003 to the Subcommittee from IRS Commissioner Everson).

<sup>424</sup> *E.g.*, The Credit Repair Organizations Act, 15 U.S.C. section 1679 *et seq.*, effective April 1, 1997 (imposing restrictions on credit repair organizations that are enforced by the Federal Trade Commission, including forbidding the making of untrue or misleading statements and forbidding advance payments; section 501(c)(3) organizations are explicitly exempt from such regulation). Testimony of Commissioner Mark Everson before the House Ways and Means Committee, Subcommittee on Oversight (November 20, 2003) (California's consumer protections laws that impose strict standards on credit service organizations and the credit repair industry do not apply to nonprofit organizations that have received a final determination from the IRS that they are exempt from tax under section 501(c)(3) and are not private foundations).

<sup>425</sup> Testimony of Commissioner Mark Everson before the House Ways and Means Committee, Subcommittee on Oversight (November 20, 2003).

Congress recently conducted hearings investigating the activities of credit counseling organizations under various consumer protection laws,<sup>426</sup> such as the Federal Trade Commission Act.<sup>427</sup> In addition, the IRS commenced a broad examination and compliance program with respect to the credit counseling industry. On May 15, 2006, the IRS announced that over the past two years, it had been auditing 63 credit counseling agencies, representing more than 40 percent of the revenue in the industry. Audits of 41 organizations, representing more than 40 percent of the revenue in the industry have been completed as of that date. All of such completed audits resulted in revocation, proposed revocation, or other termination of tax-exempt status.<sup>428</sup> In addition, the IRS released two legal documents that provide a legal framework for determining the exempt status and related issues with respect to credit counseling organizations.<sup>429</sup> In CCA 200620001, the IRS found that “[t]he critical inquiry is whether a credit counseling organization conducts its counseling program to improve an individual debtor’s understanding of his financial problems and improve his ability to address those problems.” The CCA concluded that whether a credit counseling organization primarily furthers educational purposes

can be determined by assessing the methodology by which the organization conducts its counseling activities. The process an organization uses to interview clients and develop recommendations, train its counselors and market its services can distinguish between an organization whose object is to improve a person’s knowledge and skills to manage his personal debt, and an organization that is offering counseling primarily as a mechanism to enroll individuals in a specific option (e.g., debt management plans) without considering the individual’s best interest.

Under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Public Law 109-8, an individual generally may not be a debtor in bankruptcy unless such individual has, within 180 days of filing a petition for bankruptcy, received from an approved nonprofit budget and credit counseling agency an individual or group briefing that outlines the opportunities for available credit counseling and assists the individual in performing a related

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<sup>426</sup> United States Senate Permanent Subcommittee on Investigations, Committee on Governmental Affairs, *Profiteering in a Non-Profit Industry: Abusive Practices in Credit Counseling*, Report Prepared by the Majority & Minority Staffs of the Permanent Subcommittee on Investigations and Released in Conjunction with the Permanent Subcommittee Investigations’ Hearing on March 24, 2004.

<sup>427</sup> 15 U.S.C. sec. 45(a) (prohibiting unfair and deceptive acts or practices in or affecting commerce; although the Federal Trade Commission generally lacks jurisdiction to enforce consumer protection laws against bona fide nonprofit organizations, it may assert jurisdiction over a nonprofit, including a credit counseling organization, if it demonstrates the organization is organized to carry on business for profit, is a mere instrumentality of a for-profit entity, or operates through a common enterprise with one or more for-profit entities).

<sup>428</sup> IRS News Release, IR-2006-80, May 15, 2006.

<sup>429</sup> Chief Counsel Advice 200431023 (July 13, 2004); Chief Counsel Advice 200620001 (May 9, 2006).

budget analysis.<sup>430</sup> The clerk of the court must maintain a publicly available list of nonprofit budget and credit counseling agencies approved by the U.S. Trustee (or bankruptcy administrator). In general, the U.S. Trustee (or bankruptcy administrator) shall only approve an agency that demonstrates that it will provide qualified counselors, maintain adequate provision for safekeeping and payment of client funds, provide adequate counseling with respect to client credit problems, and deal responsibly and effectively with other matters relating to the quality, effectiveness, and financial security of the services it provides. The minimum qualifications for approval of such an agency include: (1) in general, having an independent board of directors; (2) charging no more than a reasonable fee, and providing services without regard to ability to pay; (3) adequate provision for safekeeping and payment of client funds; (4) provision of full disclosures to clients; (5) provision of adequate counseling with respect to a client's credit problems; (6) trained counselors who receive no commissions or bonuses based on the outcome of the counseling services; (7) experience and background in providing credit counseling; and (8) adequate financial resources to provide continuing support services for budgeting plans over the life of any repayment plan. An individual debtor must file with the court a certificate from the approved nonprofit budget and credit counseling agency that provided the required services describing the services provided, and a copy of the debt management plan, if any, developed through the agency.<sup>431</sup>

### **Explanation of Provision**

#### **Requirements for exempt status of credit counseling organizations**

The provision establishes standards that a credit counseling organization must satisfy, in addition to present law requirements, in order to be organized and operated either as an organization described in section 501(c)(3) or in section 501(c)(4). The provision does not diminish the requirements set forth recently by the IRS in Chief Counsel Advice 200431023 or Chief Counsel Advice 200620001 but builds on and is consistent with such requirements, and the analysis therein. The provision is not intended to raise any question about IRS actions taken, and the IRS is expected to continue its vigorous examination of the credit counseling industry, applying the additional standards provided by the provision. The provision does not and is not intended to affect the approval process for credit counseling agencies under Public Law 109-8. Public Law 109-8 requires that an approved credit counseling agency be a nonprofit, and does not require that an approved agency be a section 501(c)(3) organization. It is expected that the

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<sup>430</sup> This requirement does not apply in certain circumstances, such as: (1) in general, where a debtor resides in a district for which the U.S. Trustee has determined that the approved counseling agencies for such district are not reasonably able to provide adequate services to additional individuals; (2) where exigent circumstances merit a waiver, the individual seeking bankruptcy protection files an appropriate certification with the court, and the certification is acceptable to the court; and (3) in general, where a court determines, after notice and hearing, that the individual is unable to complete the requirement because of incapacity, disability, or active military duty in a military combat zone.

<sup>431</sup> The Act also requires that, prior to discharge of indebtedness under chapter 7 or chapter 13, a debtor complete an approved instructional course concerning personal financial management, which course need not be conducted by a nonprofit agency.

Department of Justice shall continue to approve agencies for purposes of providing pre-bankruptcy counseling based on criteria that are consistent with such Public Law.

Under the provision, an organization that provides credit counseling services as a substantial purpose of the organization (“credit counseling organization”) is eligible for exemption from Federal income tax only as a charitable or educational organization under section 501(c)(3) or as a social welfare organization under section 501(c)(4), and only if (in addition to present-law requirements) the credit counseling organization is organized and operated in accordance with the following:

1. The organization provides credit counseling services tailored to the specific needs and circumstances of the consumer;
2. The organization makes no loans to debtors (other than loans with no fees or interest) and does not negotiate the making of loans on behalf of debtors;<sup>432</sup>
3. The organization provides services for the purpose of improving a consumer’s credit record, credit history, or credit rating only to the extent that such services are incidental to providing credit counseling services and does not charge any separately stated fee for any such services;<sup>433</sup>
4. The organization does not refuse to provide credit counseling services to a consumer due to inability of the consumer to pay, the ineligibility of the consumer for debt management plan enrollment, or the unwillingness of a consumer to enroll in a debt management plan;
5. The organization establishes and implements a fee policy to require that any fees charged to a consumer for its services are reasonable,<sup>434</sup> allows for the waiver of fees if the consumer is unable to pay, and except to the extent allowed by State law prohibits charging any fee based in whole or in part on a percentage of the consumer’s debt, the consumer’s payments to be made pursuant to a debt management plan, or on the projected or actual savings to the consumer resulting from enrolling in a debt management plan;

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<sup>432</sup> In general, negotiation of a loan involves negotiation of the terms of a loan, rather than the processing of a loan. Organizations that provide assistance to consumers to obtain a loan from the Department of Housing and Urban Development, for example, are not necessarily negotiating a loan for a consumer.

<sup>433</sup> Accordingly, a credit counseling organization may provide credit repair type services, but only to the extent that the provision of such services is a direct outgrowth of the provision of credit counseling services.

<sup>434</sup> Whether a credit counseling organization’s fees are consistent with specific State law requirements is evidence of the reasonableness of fees but is not determinative.

6. The organization at all times has a board of directors or other governing body (a) that is controlled by persons who represent the broad interests of the public, such as public officials acting in their capacities as such, persons having special knowledge or expertise in credit or financial education, and community leaders; (b) not more than 20 percent of the voting power of which is vested in persons who are employed by the organization or who will benefit financially, directly or indirectly, from the organization's activities (other than through the receipt of reasonable directors' fees or the repayment of consumer debt to creditors other than the credit counseling organization or its affiliates) and (c) not more than 49 percent of the voting power of which is vested in persons who are employed by the organization or who will benefit financially, directly or indirectly, from the organization's activities (other than through the receipt of reasonable directors' fees);<sup>435</sup>
7. The organization does not own (except with respect to a section 501(c)(3) organization) more than 35 percent of the total combined voting power of a corporation (or profits or beneficial interest in the case of a partnership or trust or estate) that is in the trade or business of lending money, repairing credit, or providing debt management plan services, payment processing, and similar services; and
8. The organization receives no amount for providing referrals to others for debt management plan services, and pays no amount to others for obtaining referrals of consumers.<sup>436</sup>

### **Additional requirements for charitable and educational organizations**

Under the provision, a credit counseling organization is described in section 501(c)(3) only if, in addition to satisfying the above requirements and the requirements of section 501(c)(3), the organization is organized and operated such that the organization (1) does not solicit contributions from consumers during the initial counseling process or while the consumer is receiving services from the organization and (2) the aggregate revenues of the organization that are from payments of creditors of consumers of the organization and that are attributable to debt management plan services do not exceed the applicable percentage of the total revenues of the organization. For credit counseling organizations in existence on the date of enactment, the

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<sup>435</sup> The requirements described in paragraphs 4, 5, and 6 above address core issues that are related to tax-exempt status and that have proved to be problematic in the credit counseling industry--the provision of services and waiver of fees without regard to ability to pay, the establishment of a reasonable fee policy, and the presence of independent board members. No inference is intended through the provision of these specific requirements on credit counseling organizations that similar or more stringent requirements should not be adhered to by other exempt organizations providing fees for services. Rather, the provision affirms the importance of these core issues to the matter of tax exemption, both to credit counseling organizations and to other types of exempt organizations.

<sup>436</sup> If a credit counseling organization pays or receives a fee, for example, for using or maintaining a locator service for consumers to find a credit counseling organization, such a fee is not considered a referral.

applicable percentage is 80 percent for the first taxable year of the organization beginning after the date which is one year after the date of enactment, 70 percent for the second such taxable year beginning after such date, 60 percent for the third such taxable year beginning after such date, and 50 percent thereafter. For new credit counseling organizations, the applicable percentage is 50 percent for taxable years beginning after the date of enactment. Satisfaction of the aggregate revenues requirement is not a safe harbor; all other requirements of the provision (and of section 501(c)(3)) pertaining to section 501(c)(3) organizations also must be satisfied. Satisfaction of the aggregate revenues requirement means only that an organization has not automatically failed to be organized or operated consistent with exempt purposes. Compliance with the revenues test does not mean that the organization's debt management plan services activity is at a level that organizationally or operationally is consistent with exempt status. In other words, satisfaction of the aggregate revenues requirement (as a preliminary matter in an exemption application, or on an ongoing operational basis) provides no affirmative evidence that an organization's primary purpose is an exempt purpose, or that the revenues that are subject to the limitation (or debt management plan services revenues more generally) are related to exempt purposes. As described below, whether revenues from such activity are substantially related to exempt purposes depends on the facts and circumstances, that is, satisfaction of the aggregate revenues requirement generally is not relevant for purposes of whether any of an organization's revenues are revenues from an unrelated trade or business. Failure to satisfy the aggregate revenues requirement does not disqualify the organization from recognition of exemption under section 501(c)(4).

#### **Additional requirement for social welfare organizations**

Under the provision, a credit counseling organization is described in section 501(c)(4) only if, in addition to satisfying the above requirements applicable to such organizations, the organization notifies the Secretary, in such manner as the Secretary may by regulations prescribe, that it is applying for recognition as a credit counseling organization.

#### **Debt management plan services treated as an unrelated trade or business**

Under the provision, debt management plan services are treated as an unrelated trade or business for purposes of the tax on income from an unrelated trade or business to the extent such services are provided by an organization that is not a credit counseling organization. With respect to the provision of debt management plan services by a credit counseling organization, in order for the income from such services not to be unrelated business income, it is intended that, consistent with current law, the debt management plan service with respect to such income (1) must contribute importantly to the accomplishment of credit counseling services, and (2) must not be conducted on a larger scale than reasonably is necessary for the accomplishment of such services. For example, the provision of debt management plan services would not be substantially related to accomplishing exempt purposes if the organization recommended and enrolled an individual in a debt management plan only after determining whether the individual satisfied the financial criteria established by the creditors for such plan, without (1) considering whether it was an appropriate action in light of the individual's particular needs and objectives, (2) discussing the disadvantages of a debt management plan with the consumer, and (3) presenting other possible options to such consumer.

## **Definitions**

### **Credit counseling services**

Credit counseling services are (a) the provision of educational information to the general public on budgeting, personal finance, financial literacy, saving and spending practices, and the sound use of consumer credit; (b) the assisting of individuals and families with financial problems by providing them with counseling; or (c) any combination of such activities.

### **Debt management plan services**

Debt management plan services are services related to the repayment, consolidation, or restructuring of a consumer's debt, and includes the negotiation with creditors of lower interest rates, the waiver or reduction of fees, and the marketing and processing of debt management plans.

## **Effective Date**

In general, the provision applies to taxable years beginning after the date of enactment. For a credit counseling organization that is described in section 501(c)(3) or 501(c)(4) on the date of enactment, the provision is effective for taxable years beginning after the date that is one year after the date of enactment.

## **11. Expand the base of the tax on private foundation net investment income (sec. 4940 of the Code)**

### **Present Law**

#### **In general**

Under section 4940(a) of the Code, private foundations that are recognized as exempt from Federal income tax under section 501(a) of the Code are subject to a two-percent excise tax on their net investment income. Private foundations that are not exempt from tax, such as certain charitable trusts,<sup>437</sup> also are subject to an excise tax under section 4940(b) based on net investment income and unrelated business income. The two-percent rate of tax is reduced to one-percent if certain requirements are met in a taxable year.<sup>438</sup> Unlike certain other excise taxes imposed on private foundations, the tax based on investment income does not result from a violation of substantive law by the private foundation; it is solely an excise tax.

The tax on taxable private foundations under section 4940(b) is equal to the excess of the sum of the excise tax that would have been imposed under section 4940(a) if the foundation were tax exempt and the amount of the unrelated business income tax that would have been imposed if

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<sup>437</sup> See sec. 4947(a)(1).

<sup>438</sup> Sec. 4940(e).

the foundation were tax exempt, over the income tax imposed on the foundation under subtitle A of the Code.

## **Net investment income**

### Internal Revenue Code

In general, net investment income is defined as the amount by which the sum of gross investment income and capital gain net income exceeds the deductions relating to the production of gross investment income.<sup>439</sup>

Gross investment income is the gross amount of income from interest, dividends, rents, payments with respect to securities loans, and royalties. Gross investment income does not include any income that is included in computing a foundation's unrelated business taxable income.<sup>440</sup>

Capital gain net income takes into account only gains and losses from the sale or other disposition of property used for the production of interest, dividends, rents, and royalties, and property used for the production of income included in computing the unrelated business income tax (except to the extent the gain or loss is taken into account for purposes of such tax). Losses from sales or other dispositions of property are allowed only to the extent of gains from such sales or other dispositions, and no capital loss carryovers are allowed.<sup>441</sup>

### Treasury Regulations and case law

The Treasury regulations elaborate on the Code definition of net investment income. The regulations cite items of investment income listed in the Code, and in addition clarify that net investment income includes interest, dividends, rents, and royalties derived from all sources, including from assets devoted to charitable activities. For example, interest received on a student loan is includible in the gross investment income of a foundation making the loan.<sup>442</sup>

The regulations further provide that gross investment income includes certain items of investment income that are described in the unrelated business income tax regulations.<sup>443</sup> Such additional items include payments with respect to securities loans (an item added to the Code in

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<sup>439</sup> Sec. 4940(c)(1). Net investment income also is determined by applying section 103 (generally providing an exclusion for interest on certain State and local bonds) and section 265 (generally disallowing the deduction for interest and certain other expenses with respect to tax-exempt income). Sec. 4940(c)(5).

<sup>440</sup> Sec. 4940(c)(2).

<sup>441</sup> Sec. 4940(c)(4).

<sup>442</sup> Treas. Reg. sec. 53.4940-1(d)(1).

<sup>443</sup> *Id.*

1978), annuities, income from notional principal contracts, and other substantially similar income from ordinary and routine investments to the extent determined by the Commissioner.<sup>444</sup> These latter three categories of income are not enumerated as net investment income in the Code.

The Treasury regulations also elaborate on the Code definition of capital gain net income. The regulations provide that the only capital gains and losses that are taken into account are (1) gains and losses from the sale or other disposition of property held by a private foundation for investment purposes (other than program related investments), and (2) property used for the production of income included in computing the unrelated business income tax (except to the extent the gain or loss is taken into account for purposes of such tax).

This definition of capital gain net income builds on the definition provided in the Code by providing an exception for gain and loss from program related investments and by stating, in addition, that “gains and losses from the sale or other disposition of property used for the exempt purposes of the private foundation are excluded.”<sup>445</sup> As an example, the regulations provide that gain or loss on the sale of buildings used for the foundation’s exempt activities are not taken into account for purposes of the section 4940 tax. If a foundation uses exempt income for exempt purposes and (other than incidentally) for investment purposes, then the portion of the gain or loss received upon sale or other disposition that is allocable to the investment use is taken into account for purposes of the tax.

The regulations further provide that “property shall be treated as held for investment purposes even though such property is disposed of by the foundation immediately upon its receipt, if it is property of a type which generally produces interest, dividends, rents, royalties, or capital gains through appreciation (for example, rental real estate, stock, bonds, mineral interest, mortgages, and securities).”<sup>446</sup>

This regulation has been challenged in the courts. The regulation says that property is treated as held for investment purposes if it is of a type that “generally produces” certain types of income. By contrast, the Code provides that the property be “used” to produce such income. In *Zemurray Foundation v. United States*, 687 F.2d 97 (5th Cir. 1982), the taxpayer foundation challenged the Treasury’s attempt to tax under section 4940 capital gain on the sale of timber property. The taxpayer asserted that the property was not actually used to produce investment income, and that the Treasury Regulation was invalid because the regulation would subject to tax property that is of a type that could generally be used to produce investment income. On this issue, the court upheld the Treasury regulation, reasoning that the regulation’s use of the phrase “generally used,” though permitting taxation “so long as the property sold is usable to produce the applicable types of income, regardless of whether the property is actually used to produce income or not” was not unreasonable or plainly inconsistent with the statute.<sup>447</sup> However, on

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<sup>444</sup> Treas. Reg. sec. 1.512(b)-1(a)(1).

<sup>445</sup> Treas. Reg. sec. 53.4940-1(f)(1).

<sup>446</sup> *Id.*

<sup>447</sup> *Zemurray Foundation v. United States*, 687 F.2d 97, 100 (5<sup>th</sup> Cir. 1982).

remand to the district court, the district court concluded that the timber property at issue, though a type of property generally used to produce investment income, was not susceptible for such use.<sup>448</sup> Thus, the district court concluded that the Treasury could not tax the gain under this portion of the regulation.

The question then turned to the taxpayer's second challenge to the regulation. At issue was the meaning of the regulatory phrase "capital gains through appreciation." The regulation provides that if property is of a type that generally produces capital gains through appreciation, then the gain is subject to tax. The Treasury argued that the timber property at issue, although held by the court not to be property (in this case) susceptible for use to produce interest, dividends, rents, or royalties, still was held by the taxpayer to produce capital gain through appreciation and therefore the gain should be subject to tax under the regulation.

On this issue, the court held for the taxpayer, reasoning that the language of the Code clearly is limited to certain gains and losses, e.g., the court cited the Code language providing that "there shall be taken into account only gains and losses from the sale or other disposition of property used for the production of interest, dividends, rents, and royalties . . . ."<sup>449</sup> The court noted that "capital gains through appreciation" is not enumerated in the statute. The court used as an example a jade figurine held by a foundation. Jade figurines do not generally produce interest, dividends, rents, or royalties, but gain on the sale of such a figurine would be taxable under the "capital gains through appreciation" standard, yet such standard does not appear in the statute. After *Zemurray*, the Treasury generally conceded this issue.<sup>450</sup>

With respect to capital losses, the Code provides that carryovers are not permitted, whereas the regulations state that neither carryovers nor carrybacks are permitted.<sup>451</sup>

#### Application of *Zemurray* to the Code and the regulations

Applying the *Zemurray* case to the Code and regulations results in a general principle for purposes of present law: private foundations are subject to tax under section 4940 only on the items of income and only on gains and losses specifically enumerated therein. Under this principle, private foundations generally are not subject to the section 4940 tax on other substantially similar types of income from ordinary and routine investments, notwithstanding Treasury regulations to the contrary. In addition, the regulations provide that gain or loss from the sale or other disposition of assets used for exempt purposes, with specific reference to program-related investments, is excluded. The Code provides for no such blanket exclusion; thus, under the language of the Code and the reasoning of *Zemurray*, if a foundation provided

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<sup>448</sup> *Zemurray Foundation v. United States*, 53 A.F.T.R. 2d (RIA) 842 (E. D. La. 1983).

<sup>449</sup> *Zemurray Foundation v. United States*, 755 F.2d 404 (5<sup>th</sup> Cir. 1985), 413 (citing Code sec. 4940(c)(4)(A)).

<sup>450</sup> G.C.M. 39538 (July 23, 1986).

<sup>451</sup> Treas. Reg. sec. 53.4940-1(f)(3).

office space at below market rent to a charitable organization for use in the organization's exempt purposes, gain on the sale of the building by the foundation should be subject to the section 4940 tax despite the Treasury regulations.<sup>452</sup>

In addition, under the logic of Zemurray, capital loss carrybacks arguably are permitted, notwithstanding Treasury regulations to the contrary, because the Code mentions only a bar on use of carryovers and says nothing about carrybacks.

### **Explanation of Provision**

The provision amends the definition of gross investment income (including for purposes of capital gain net income) to include items of income that are similar to the items presently enumerated in the Code. Such similar items include income from notional principal contracts, annuities, and other substantially similar income from ordinary and routine investments, and, with respect to capital gain net income, capital gains from appreciation, including capital gains and losses from the sale or other disposition of assets used to further an exempt purpose.

Certain gains and losses are not taken into account in determining capital gain net income. Specifically, under the provision, no gain or loss shall be taken into account with respect to any portion of property used for a period of not less than one year for a purpose or function constituting the basis of the private foundation's exemption, if the entire property is exchanged immediately following such period solely for property of like kind which is to be used primarily for a purpose or function constituting the basis for such foundation's exemption. Rules similar to the rules of section 1031 (relating to exchange of property held for productive use or investment) apply, including, but not limited to, the exceptions of section 1031(a)(2) and the rule of section 1031(a)(3) regarding completion of the exchange within 180 days.

The provision provides that there are no carrybacks of losses from sales or other dispositions of property.

### **Effective Date**

The provision is effective for taxable years beginning after the date of enactment.

## **12. Definition of convention or association of churches (sec. 7701 of the Code)**

### **Present Law**

Under present law, an organization that qualifies as a "convention or association of churches" (within the meaning of sec. 170(b)(1)(A)(i)) is not required to file an annual return,<sup>453</sup> is subject to the church tax inquiry and church tax examination provisions applicable to

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<sup>452</sup> See also the example in Treas. Reg. sec. 53.4940-1(f)(1).

<sup>453</sup> Sec. 6033(a)(2)(A)(i).

organizations claiming to be a church,<sup>454</sup> and is subject to certain other provisions generally applicable to churches.<sup>455</sup> The Internal Revenue Code does not define the term “convention or association of churches.”

### **Explanation of Provision**

The provision provides that an organization that otherwise is a convention or association of churches does not fail to so qualify merely because the membership of the organization includes individuals as well as churches, or because individuals have voting rights in the organization.

### **Effective Date**

The provision is effective on the date of enactment.

## **13. Notification requirement for exempt entities not currently required to file an annual information return (secs. 6033, 6652, and 7428 of the Code)**

### **Present Law**

Under present law, the requirement that an exempt organization file an annual information return does not apply to several categories of exempt organizations. Organizations excepted from the filing requirement include organizations (other than private foundations), the gross receipts of which in each taxable year normally are not more than \$25,000.<sup>456</sup> Also exempt from the requirement are churches, their integrated auxiliaries, and conventions or associations of churches; the exclusively religious activities of any religious order; section 501(c)(1)

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<sup>454</sup> Sec. 7611(h)(1)(B).

<sup>455</sup> *See, e.g.*, Sec. 402(g)(8)(B) (limitation on elective deferrals); sec. 403(b)(9)(B) (definition of retirement income account); sec. 410(d) (election to have participation, vesting, funding, and certain other provisions apply to church plans); sec. 414(e) (definition of church plan); sec. 415(c)(7) (certain contributions by church plans); sec. 501(h)(5) (disqualification of certain organizations from making the sec. 501(h) election regarding lobbying expenditure limits); sec. 501(m)(3) (definition of commercial-type insurance); sec. 508(c)(1)(A) (exception from requirement to file application seeking recognition of exempt status); sec. 512(b)(12) (allowance of up to \$1,000 deduction for purposes of determining unrelated business taxable income); sec. 514(b)(3)(E) (definition of debt-financed property); sec. 3121(w)(3)(A) (election regarding exemption from social security taxes); sec. 3309(b)(1) (application of federal unemployment tax provisions to services performed in the employ of certain organizations); sec. 6043(b)(1) (requirement to file a return upon liquidation or dissolution of the organization); and sec. 7702(j)(3)(A) (treatment of certain death benefit plans as life insurance).

<sup>456</sup> Sec. 6033(a)(2); Treas. Reg. sec. 1.6033-2(a)(2)(i); Treas. Reg. sec. 1.6033-2(g)(1). Sec. 6033(a)(2)(A)(ii) provides a \$5,000 annual gross receipts exception from the annual reporting requirements for certain exempt organizations. In Announcement 82-88, 1982-25 I.R.B. 23, the IRS exercised its discretionary authority under section 6033 to increase the gross receipts exception to \$25,000, and enlarge the category of exempt organizations that are not required to file Form 990.

instrumentalities of the United States; section 501(c)(21) trusts; an interchurch organization of local units of a church; certain mission societies; certain church-affiliated elementary and high schools; certain State institutions whose income is excluded from gross income under section 115; certain governmental units and affiliates of governmental units; and other organizations that the IRS has relieved from the filing requirement pursuant to its statutory discretionary authority.

### **Explanation of Provision**

The provision requires organizations that are excused from filing an information return by reason of normally having gross receipts below a certain specified amount (generally, under \$25,000) to furnish to the Secretary annually, in electronic form, the legal name of the organization, any name under which the organization operates or does business, the organization's mailing address and Internet web site address (if any), the organization's taxpayer identification number, the name and address of a principal officer, and evidence of the organization's continuing basis for its exemption from the generally applicable information return filing requirements. Upon such organization's termination of existence, the organization is required to furnish notice of such termination.

The provision provides that if an organization fails to provide the required notice for three consecutive years, the organization's tax-exempt status is revoked. In addition, if an organization that is required to file an annual information return under section 6033(a) (Form 990) fails to file such an information return for three consecutive years, the organization's tax-exempt status is revoked. If an organization fails to meet its filing obligation to the IRS for three consecutive years in cases where the organization is subject to the information return filing requirement in one or more years during a three-year period and also is subject to the notice requirement for one or more years during the same three-year period, the organization's tax-exempt status is revoked.

A revocation under the provision is effective from the date that the Secretary determines was the last day the organization could have timely filed the third required information return or notice. To again be recognized as tax-exempt, the organization must apply to the Secretary for recognition of tax-exemption, irrespective of whether the organization was required to make an application for recognition of tax-exemption in order to gain tax-exemption originally.

If, upon application for tax-exempt status after a revocation under the provision, the organization shows to the satisfaction of the Secretary reasonable cause for failing to file the required annual notices or returns, the organization's tax-exempt status may, in the discretion of the Secretary, be reinstated retroactive to the date of revocation. An organization may not challenge under the Code's declaratory judgment procedures (section 7428) a revocation of tax-exemption made pursuant to the provision.

There is no monetary penalty for failure to file the notice under the provision. Like other information returns, the notices are subject to the public disclosure and inspection rules generally applicable to exempt organizations. The provision does not affect an organization's obligation under present law to file required information returns or existing penalties for failure to file such returns.

The Secretary is required to notify every organization that is subject to the notice filing requirement of the new filing obligation in a timely manner. Notification by the Secretary shall be by mail, in the case of any organization the identity and address of which is included in the list of exempt organizations maintained by the Secretary, and by Internet or other means of outreach, in the case of any other organization. In addition, the Secretary is required to publicize in a timely manner in appropriate forms and instructions and other means of outreach the new penalty imposed for consecutive failures to file the information return.

The Secretary is authorized to publish a list of organizations whose exempt status is revoked under the provision.

### **Effective Date**

The provision is effective for notices and returns with respect to annual periods beginning after 2006.

## **14. Disclosure to State officials relating to section 501(c) organizations (secs. 6103, 6104, 7213, 7213A, and 7431 of the Code)**

### **Present Law**

In the case of organizations that are described in section 501(c)(3) and exempt from tax under section 501(a) or that have applied for exemption as an organization so described, present law (sec. 6104(c)) requires the Secretary to notify the appropriate State officer of (1) a refusal to recognize such organization as an organization described in section 501(c)(3), (2) a revocation of a section 501(c)(3) organization's tax-exempt status, and (3) the mailing of a notice of deficiency for any tax imposed under section 507, chapter 41, or chapter 42.<sup>457</sup> In addition, at the request of such appropriate State officer, the Secretary is required to make available for inspection and copying, such returns, filed statements, records, reports, and other information relating to the above-described disclosures, as are relevant to any State law determination. An appropriate State officer is the State attorney general, State tax officer, or any State official charged with overseeing organizations of the type described in section 501(c)(3).

In general, returns and return information (as such terms are defined in section 6103(b)) are confidential and may not be disclosed or inspected unless expressly provided by law.<sup>458</sup> Present law requires the Secretary to keep records of disclosures and requests for inspection<sup>459</sup>

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<sup>457</sup> The applicable taxes include the termination tax on private foundations; taxes on public charities for certain excess lobbying expenses; taxes on a private foundation's net investment income, self-dealing activities, undistributed income, excess business holdings, investments that jeopardize charitable purposes, and taxable expenditures (some of these taxes also apply to certain non-exempt trusts); taxes on the political expenditures and excess benefit transactions of section 501(c)(3) organizations; and certain taxes on black lung benefit trusts and foreign organizations.

<sup>458</sup> Sec. 6103(a).

<sup>459</sup> Sec. 6103(p)(3).

and requires that persons authorized to receive returns and return information maintain various safeguards to protect such information against unauthorized disclosure.<sup>460</sup> Willful unauthorized disclosure or inspection of returns or return information is subject to a fine and/or imprisonment.<sup>461</sup> The knowing or negligent unauthorized inspection or disclosure of returns or return information gives the taxpayer a right to bring a civil suit.<sup>462</sup> Such present-law protections against unauthorized disclosure or inspection of returns and return information do not apply to the disclosures or inspections, described above, that are authorized by section 6104(c).

### **Explanation of Provision**

The provision provides that upon written request by an appropriate State officer, the Secretary may disclose: (1) a notice of proposed refusal to recognize an organization as a section 501(c)(3) organization; (2) a notice of proposed revocation of tax-exemption of a section 501(c)(3) organization; (3) the issuance of a proposed deficiency of tax imposed under section 507, chapter 41, or chapter 42; (4) the names, addresses, and taxpayer identification numbers of organizations that have applied for recognition as section 501(c)(3) organizations; and (5) returns and return information of organizations with respect to which information has been disclosed under (1) through (4) above.<sup>463</sup> Disclosure or inspection is permitted for the purpose of, and only to the extent necessary in, the administration of State laws regulating section 501(c)(3) organizations, such as laws regulating tax-exempt status, charitable trusts, charitable solicitation, and fraud. Such disclosure or inspection may be made only to or by an appropriate State officer or to an officer or employee of the State who is designated by the appropriate State officer, and may not be made by or to a contractor or agent. The Secretary also is permitted to disclose or open to inspection the returns and return information of an organization that is recognized as tax-exempt under section 501(c)(3), or that has applied for such recognition, to an appropriate State officer if the Secretary determines that disclosure or inspection may constitute evidence of noncompliance under the laws within the jurisdiction of the appropriate State officer. For this purpose, appropriate State officer means the State attorney general, the State tax officer, or any other State official charged with overseeing organizations of the type described in section 501(c)(3).

In addition, the provision provides that upon the written request by an appropriate State officer, the Secretary may make available for inspection or disclosure returns and return information of an organization described in section 501(c) (other than section 501(c)(1) or section 501(c)(3)). Such returns and return information are available for inspection or disclosure only for the purpose of, and to the extent necessary in, the administration of State laws regulating the solicitation or administration of the charitable funds or charitable assets of such

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<sup>460</sup> Sec. 6103(p)(4).

<sup>461</sup> Secs. 7213 and 7213A.

<sup>462</sup> Sec. 7431.

<sup>463</sup> Such returns and return information also may be open to inspection by an appropriate State officer.

organizations. Such disclosure or inspection may be made only to or by an appropriate State officer or to an officer or employee of the State who is designated by the appropriate State officer, and may not be made by or to a contractor or agent. For this purpose, appropriate State officer means the State attorney general, the State tax officer, and the head of an agency designated by the State attorney general as having primary responsibility for overseeing the solicitation of funds for charitable purposes of such organizations.

In addition, the provision provides that any returns and return information disclosed under section 6104(c) may be disclosed in civil administrative and civil judicial proceedings pertaining to the enforcement of State laws regulating the applicable tax-exempt organization in a manner prescribed by the Secretary. Returns and return information are not to be disclosed under section 6104(c), or in such an administrative or judicial proceeding, to the extent that the Secretary determines that such disclosure would seriously impair Federal tax administration. The provision makes disclosures of returns and return information under section 6104(c) subject to the disclosure, recordkeeping, and safeguard provisions of section 6103, including through requirements that the Secretary maintain a permanent system of records of requests for disclosure (sec. 6103(p)(3)) and that the appropriate State officer maintain various safeguards that protect against unauthorized disclosure (sec. 6103(p)(4)). The provision provides that the willful unauthorized disclosure of returns or return information described in section 6104(c) is a felony subject to a fine of up to \$5,000 and/or imprisonment of up to five years (sec. 7213(a)(2)), the willful unauthorized inspection of returns or return information described in section 6104(c) is subject to a fine of up to \$1,000 and/or imprisonment of up to one year (sec. 7213A), and provides the taxpayer the right to bring a civil action for damages in the case of knowing or negligent unauthorized disclosure or inspection of such information (sec. 7431(a)(2)).

#### **Effective Date**

The provision is effective on the date of enactment but does not apply to requests made before such date.

### **15. Require that unrelated business income tax returns of section 501(c)(3) organizations be made publicly available (sec. 6104 of the Code)**

#### **Present Law**

In general, an organization described in section 501(c) or (d) is required to make available for public inspection a copy of its annual information return (Form 990) and exemption application materials.<sup>464</sup> A penalty may be imposed on any person who does not make an organization's annual returns or exemption application materials available for public inspection. The penalty amount is \$20 for each day during which a failure occurs. If more than one person fails to comply, each person is jointly and severally liable for the full amount of the penalty. The maximum penalty that may be imposed on all persons for any one annual return is \$10,000. There is no maximum penalty amount for failing to make exemption application materials

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<sup>464</sup> Sec. 6104(d).

available for public inspection. Any person who willfully fails to comply with the public inspection requirements is subject to an additional penalty of \$5,000.<sup>465</sup>

These requirements do not apply to an organization's annual return for unrelated business income tax (generally Form 990-T).<sup>466</sup>

### **Explanation of Provision**

The provision extends the present-law public inspection and disclosure requirements and penalties applicable to the Form 990 to the unrelated business income tax return (Form 990-T) of organizations described in section 501(c)(3). The provision provides that certain information may be withheld by the organization from public disclosure and inspection if public availability would adversely affect the organization, similar to the information that may be withheld under present law with respect to applications for tax exemption and the Form 990 (e.g., information relating to a trade secret, patent, process, style of work, or apparatus of the organization, if the Secretary determines that public disclosure of such information would adversely affect the organization).

### **Effective Date**

The provision is effective for returns filed after the date of enactment.

## **16. Treasury study on donor advised funds and supporting organizations**

### **Present Law**

#### **Donor advised funds**

Some charitable organizations (including community foundations) establish accounts to which donors may contribute and thereafter provide nonbinding advice or recommendations with regard to distributions from the fund or the investment of assets in the fund. Such accounts are commonly referred to as "donor advised funds." Donors who make contributions to charities for maintenance in a donor advised fund generally claim a charitable contribution deduction at the time of the contribution. Although sponsoring charities frequently permit donors (or other persons appointed by donors) to provide nonbinding recommendations concerning the distribution or investment of assets in a donor advised fund, sponsoring charities generally must have legal ownership and control of such assets following the contribution. If the sponsoring charity does not have such control (or permits a donor to exercise control over amounts contributed), the donor's contributions may not qualify for a charitable deduction, and, in the case of a community foundation, the contribution may be treated as being subject to a material restriction or condition by the donor.

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<sup>465</sup> Sec. 6685.

<sup>466</sup> Treas. Reg. sec. 301.6104(d)-1(b)(4)(ii).

In recent years, a number of financial institutions have formed charitable corporations for the principal purpose of offering donor advised funds, sometimes referred to as “commercial” donor advised funds. In addition, some established charities have begun operating donor advised funds in addition to their primary activities. The IRS has recognized several organizations that sponsor donor advised funds, including “commercial” donor advised funds, as section 501(c)(3) public charities. The term “donor advised fund” is not defined in statute or regulations.

### **Supporting organizations**

The Code provides that certain “supporting organizations” (in general, organizations that provide support to another section 501(c)(3) organization that is not a private foundation) are classified as public charities rather than private foundations.<sup>467</sup> To qualify as a supporting organization, an organization must meet all three of the following tests: (1) it must be organized and at all times operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more “publicly supported organizations”<sup>468</sup> (the “organizational and operational tests”);<sup>469</sup> (2) it must be operated, supervised, or controlled by or in connection with one or more publicly supported organizations (the “relationship test”);<sup>470</sup> and (3) it must not be controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more publicly supported organizations (the “lack of outside control test”).<sup>471</sup>

To satisfy the relationship test, a supporting organization must hold one of three statutorily described close relationships with the supported organization. The organization must be: (1) operated, supervised, or controlled by a publicly supported organization (commonly referred to as “Type I” supporting organizations); (2) supervised or controlled in connection with a publicly supported organization (“Type II” supporting organizations); or (3) operated in connection with a publicly supported organization (“Type III” supporting organizations).<sup>472</sup>

#### Type I supporting organizations

In the case of supporting organizations that are operated, supervised, or controlled by one or more publicly supported organizations (Type I supporting organizations), one or more supported organizations must exercise a substantial degree of direction over the policies,

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<sup>467</sup> Sec. 509(a)(3).

<sup>468</sup> In general, supported organizations of a supporting organization must be publicly supported charities described in sections 509(a)(1) or (a)(2).

<sup>469</sup> Sec. 509(a)(3)(A).

<sup>470</sup> Sec. 509(a)(3)(B).

<sup>471</sup> Sec. 509(a)(3)(C).

<sup>472</sup> Treas. Reg. sec. 1.509(a)-4(f)(2).

programs, and activities of the supporting organization.<sup>473</sup> The relationship between the Type I supporting organization and the supported organization generally is comparable to that of a parent and subsidiary. The requisite relationship may be established by the fact that a majority of the officers, directors, or trustees of the supporting organization are appointed or elected by the governing body, members of the governing body, officers acting in their official capacity, or the membership of one or more publicly supported organizations.<sup>474</sup>

#### Type II supporting organizations

Type II supporting organizations are supervised or controlled in connection with one or more publicly supported organizations. Rather than the parent-subsidiary relationship characteristic of Type I organizations, the relationship between a Type II organization and its supported organizations is more analogous to a brother-sister relationship. In order to satisfy the Type II relationship requirement, generally there must be common supervision or control by the persons supervising or controlling both the supporting organization and the publicly supported organizations.<sup>475</sup> An organization generally is not considered to be “supervised or controlled in connection with” a publicly supported organization merely because the supporting organization makes payments to the publicly supported organization, even if the obligation to make payments is enforceable under state law.<sup>476</sup>

#### Type III supporting organizations

Type III supporting organizations are “operated in connection with” one or more publicly supported organizations. To satisfy the “operated in connection with” relationship, Treasury regulations require that the supporting organization be responsive to, and significantly involved in the operations of, the publicly supported organization. This relationship is deemed to exist where the supporting organization meets both a “responsiveness test” and an “integral part test.”<sup>477</sup> In general, the responsiveness test requires that the Type III supporting organization be responsive to the needs or demands of the publicly supported organizations. In general, the integral part test requires that the Type III supporting organization maintain significant involvement in the operations of one or more publicly supported organizations, and that such publicly supported organizations are in turn dependent upon the supporting organization for the type of support which it provides.

There are two alternative methods for satisfying the integral part test. The first alternative is to establish that (1) the activities engaged in for or on behalf of the publicly

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<sup>473</sup> Treas. Reg. sec. 1.509(a)-4(g)(1)(i).

<sup>474</sup> Id.

<sup>475</sup> Treas. Reg. sec. 1.509(a)-4(h)(1).

<sup>476</sup> Treas. Reg. sec. 1.509(a)-4(h)(2).

<sup>477</sup> Treas. Reg. sec. 1.509(a)-4(i)(1).

supported organization are activities to perform the functions of, or carry out the purposes of, such organizations; and (2) these activities, but for the involvement of the supporting organization, normally would be engaged in by the publicly supported organizations themselves.<sup>478</sup> Organizations that satisfy this “but for” test sometimes are referred to as “functionally integrated” Type III supporting organizations. The second method for satisfying the integral part test is to establish that: (1) the supporting organization pays substantially all of its income to or for the use of one or more publicly supported organizations;<sup>479</sup> (2) the amount of support received by one or more of the publicly supported organizations is sufficient to insure the attentiveness of the organization or organizations to the operations of the supporting organization (this is known as the “attentiveness requirement”);<sup>480</sup> and (3) a significant amount of the total support of the supporting organization goes to those publicly supported organizations that meet the attentiveness requirement.<sup>481</sup>

### **Explanation of Provision**

Elsewhere in the bill, provision is made for new rules with respect to donor advised funds and supporting organizations. Many issues arise under current law with respect to such organizations, some of which are addressed by the bill and some of which would benefit from additional study. The provision provides that the Secretary of the Treasury shall undertake a study on the organization and operation of donor advised funds (as defined in section 4966(d)(2)) and of supporting organizations (organizations described in section 509(a)(3)). The study shall specifically consider (1) whether the amount and availability of the income, gift, or estate tax charitable deductions allowed for charitable contributions to sponsoring organizations (as defined in section 4966(d)(1)) of donor advised funds or to organizations described in section 509(a)(3) is appropriate in consideration of (i) the use of contributed assets (including the type, extent, and timing of such use) or (ii) the use of the assets of such organizations for the benefit of the person making the charitable contribution (or a person related to such person), (2) whether donor advised funds should be required to distribute for charitable purposes a specified amount (whether based on the income or assets of the fund) in order to ensure that the sponsoring organization with respect to the fund is operating consistent with the purposes or functions constituting the basis for its exemption under section 501 or its status as an organization

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<sup>478</sup> Treas. Reg. sec. 1.509(a)-4(i)(3)(ii).

<sup>479</sup> For this purpose, the IRS has defined the term “substantially all” of an organization's income to mean 85 percent or more. Rev. Rul. 76-208, 1976-1 C.B. 161.

<sup>480</sup> Although the regulations do not specify the requisite level of support in numerical or percentage terms, the IRS has suggested that grants that represent less than 10 percent of the beneficiary's support likely would be viewed as insufficient to ensure attentiveness. Gen. Couns. Mem. 36379 (August 15, 1975). As an alternative to satisfying the attentiveness standard by the foregoing method, a supporting organization may demonstrate attentiveness by showing that, in order to avoid the interruption of the carrying on of a particular function or activity, the beneficiary organization will be sufficiently attentive to the operations of the supporting organization. Treas. Reg. sec. 1.509(a)-4(i)(3)(iii)(b).

<sup>481</sup> Treas. Reg. sec. 1.509(a)-4(i)(3)(iii).

described in section 509(a), (3) whether the retention by donors to donor advised funds or supporting organizations of rights or privileges with respect to amounts transferred to such organizations (including advisory rights or privileges with respect to the making of grants or the investment of assets) is consistent with the treatment of such transfers as completed gifts that qualify for an income, gift, or estate tax charitable deduction, and (4) whether any of the issues addressed above also raise issues with respect to other forms of charities or charitable donations.

Not later than one year after the date of enactment of this Act, the Secretary shall submit a report on the study, comment on any actions (audits, guidance, regulations, etc.) taken by the Secretary with respect to the issues discussed in the study, and make recommendations to the Committee on Finance of the Senate and the Committee on Ways and Means of the House of Representatives.

### **Effective Date**

The provision is effective on the date of enactment.

## **17. Improve accountability of donor advised funds (new secs. 4966 and 4967 of the Code)**

### **Present Law**

#### **Requirements for section 501(c)(3) tax-exempt status**

Charitable organizations, i.e., organizations described in section 501(c)(3), generally are exempt from Federal income tax and are eligible to receive tax deductible contributions. A charitable organization must operate primarily in pursuance of one or more tax-exempt purposes constituting the basis of its tax exemption.<sup>482</sup> In order to qualify as operating primarily for a purpose described in section 501(c)(3), an organization must satisfy the following operational requirements: (1) the net earnings of the organization may not inure to the benefit of any person in a position to influence the activities of the organization; (2) the organization must operate to provide a public benefit, not a private benefit;<sup>483</sup> (3) the organization may not be operated primarily to conduct an unrelated trade or business;<sup>484</sup> (4) the organization may not engage in substantial legislative lobbying; and (5) the organization may not participate or intervene in any political campaign.

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<sup>482</sup> Treas. Reg. sec. 1.501(c)(3)-1(c)(1). The Code specifies such purposes as religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster international amateur sports competition, or for the prevention of cruelty to children or animals. In general, an organization is organized and operated for charitable purposes if it provides relief for the poor and distressed or the underprivileged. Treas. Reg. sec. 1.501(c)(3)-1(d)(2).

<sup>483</sup> Treas. Reg. sec. 1.501(c)(3)-1(d)(1)(ii).

<sup>484</sup> Treas. Reg. sec. 1.501(c)(3)-1(e)(1). Conducting a certain level of unrelated trade or business activity will not jeopardize tax-exempt status.

## **Classification of section 501(c)(3) organizations**

Section 501(c)(3) organizations are classified either as “public charities” or “private foundations.”<sup>485</sup> Private foundations generally are defined under section 509(a) as all organizations described in section 501(c)(3) other than an organization granted public charity status by reason of: (1) being a specified type of organization (i.e., churches, educational institutions, hospitals and certain other medical organizations, certain organizations providing assistance to colleges and universities, or a governmental unit); (2) receiving a substantial part of its support from governmental units or direct or indirect contributions from the general public; or (3) providing support to another section 501(c)(3) entity that is not a private foundation. In contrast to public charities, private foundations generally are funded from a limited number of sources (e.g., an individual, family, or corporation). Donors to private foundations and persons related to such donors together often control the operations of private foundations.

Because private foundations receive support from, and typically are controlled by, a small number of supporters, private foundations are subject to a number of anti-abuse rules and excise taxes not applicable to public charities.<sup>486</sup> For example, the Code imposes excise taxes on acts of “self-dealing” between disqualified persons (generally, an enumerated class of foundation insiders<sup>487</sup>) and a private foundation. Acts of self-dealing include, for example, sales or exchanges, or leasing, of property; lending of money; or the furnishing of goods, services, or facilities between a disqualified person and a private foundation.<sup>488</sup> In addition, private non-operating foundations are required to pay out a minimum amount each year as qualifying distributions. In general, a qualifying distribution is an amount paid to accomplish one or more of the organization’s exempt purposes, including reasonable and necessary administrative expenses.<sup>489</sup> Certain expenditures of private foundations are also subject to tax.<sup>490</sup> In general, taxable expenditures are expenditures: (1) for lobbying; (2) to influence the outcome of a public election or carry on a voter registration drive (unless certain requirements are met); (3) as a grant to an individual for travel, study, or similar purposes unless made pursuant to procedures approved by the Secretary; (4) as a grant to an organization that is not a public charity or exempt

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<sup>485</sup> Sec. 509(a). Private foundations are either private operating foundations or private non-operating foundations. In general, private operating foundations operate their own charitable programs in contrast to private non-operating foundations, which generally are grant-making organizations. Most private foundations are non-operating foundations.

<sup>486</sup> Secs. 4940 - 4945.

<sup>487</sup> See sec. 4946(a).

<sup>488</sup> Sec. 4941.

<sup>489</sup> Sec. 4942(g)(1)(A). A qualifying distribution also includes any amount paid to acquire an asset used (or held for use) directly in carrying out one or more of the organization’s exempt purposes and certain amounts set-aside for exempt purposes. Sec. 4942(g)(1)(B) and 4942(g)(2).

<sup>490</sup> Sec. 4945. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

operating foundation unless the foundation exercises expenditure responsibility<sup>491</sup> with respect to the grant; or (5) for any non-charitable purpose. Additional excise taxes may also apply in the event a private foundation holds certain business interests (“excess business holdings”)<sup>492</sup> or makes an investment that jeopardizes the foundation’s exempt purposes.<sup>493</sup>

### **Supporting organizations**

The Code provides that certain “supporting organizations” (in general, organizations that provide support to another section 501(c)(3) organization that is not a private foundation) are classified as public charities rather than private foundations.<sup>494</sup> To qualify as a supporting organization, an organization must meet all three of the following tests: (1) it must be organized and at all times operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more “publicly supported organizations”<sup>495</sup> (the “organizational and operational tests”);<sup>496</sup> (2) it must be operated, supervised, or controlled by or in connection with one or more publicly supported organizations (the “relationship test”);<sup>497</sup> and (3) it must not be controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more publicly supported organizations (the “lack of outside control test”).<sup>498</sup>

To satisfy the relationship test, a supporting organization must hold one of three statutorily described close relationships with the supported organization. The organization must be: (1) operated, supervised, or controlled by a publicly supported organization (commonly referred to as “Type I” supporting organizations); (2) supervised or controlled in connection with a publicly supported organization (“Type II” supporting organizations); or (3) operated in connection with a publicly supported organization (“Type III” supporting organizations).<sup>499</sup>

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<sup>491</sup> In general, expenditure responsibility requires that a foundation make all reasonable efforts and establish reasonable procedures to ensure that the grant is spent solely for the purpose for which it was made, to obtain reports from the grantee on the expenditure of the grant, and to make reports to the Secretary regarding such expenditures. Sec. 4945(h).

<sup>492</sup> Sec. 4943.

<sup>493</sup> Sec. 4944.

<sup>494</sup> Sec. 509(a)(3).

<sup>495</sup> In general, supported organizations of a supporting organization must be publicly supported charities described in sections 509(a)(1) or (a)(2).

<sup>496</sup> Sec. 509(a)(3)(A).

<sup>497</sup> Sec. 509(a)(3)(B).

<sup>498</sup> Sec. 509(a)(3)(C).

<sup>499</sup> Treas. Reg. sec. 1.509(a)-4(f)(2).

### Type I supporting organizations

In the case of supporting organizations that are operated, supervised, or controlled by one or more publicly supported organizations (Type I supporting organizations), one or more supported organizations must exercise a substantial degree of direction over the policies, programs, and activities of the supporting organization.<sup>500</sup> The relationship between the Type I supporting organization and the supported organization generally is comparable to that of a parent and subsidiary. The requisite relationship may be established by the fact that a majority of the officers, directors, or trustees of the supporting organization are appointed or elected by the governing body, members of the governing body, officers acting in their official capacity, or the membership of one or more publicly supported organizations.<sup>501</sup>

### Type II supporting organizations

Type II supporting organizations are supervised or controlled in connection with one or more publicly supported organizations. Rather than the parent-subsidiary relationship characteristic of Type I organizations, the relationship between a Type II organization and its supported organizations is more analogous to a brother-sister relationship. In order to satisfy the Type II relationship requirement, generally there must be common supervision or control by the persons supervising or controlling both the supporting organization and the publicly supported organizations.<sup>502</sup> An organization generally is not considered to be “supervised or controlled in connection with” a publicly supported organization merely because the supporting organization makes payments to the publicly supported organization, even if the obligation to make payments is enforceable under state law.<sup>503</sup>

### Type III supporting organizations

Type III supporting organizations are “operated in connection with” one or more publicly supported organizations. To satisfy the “operated in connection with” relationship, Treasury regulations require that the supporting organization be responsive to, and significantly involved in the operations of, the publicly supported organization. This relationship is deemed to exist where the supporting organization meets both a “responsiveness test” and an “integral part test.”<sup>504</sup> In general, the responsiveness test requires that the Type III supporting organization be responsive to the needs or demands of the publicly supported organizations. In general, the integral part test requires that the Type III supporting organization maintain significant involvement in the operations of one or more publicly supported organizations, and that such

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<sup>500</sup> Treas. Reg. sec. 1.509(a)-4(g)(1)(i).

<sup>501</sup> Id.

<sup>502</sup> Treas. Reg. sec. 1.509(a)-4(h)(1).

<sup>503</sup> Treas. Reg. sec. 1.509(a)-4(h)(2).

<sup>504</sup> Treas. Reg. sec. 1.509(a)-4(i)(1).

publicly supported organizations are in turn dependent upon the supporting organization for the type of support which it provides.

There are two alternative methods for satisfying the integral part test. The first alternative is to establish that (1) the activities engaged in for or on behalf of the publicly supported organization are activities to perform the functions of, or carry out the purposes of, such organizations; and (2) these activities, but for the involvement of the supporting organization, normally would be engaged in by the publicly supported organizations themselves.<sup>505</sup> Organizations that satisfy this “but for” test sometimes are referred to as “functionally integrated” Type III supporting organizations. The second method for satisfying the integral part test is to establish that: (1) the supporting organization pays substantially all of its income to or for the use of one or more publicly supported organizations;<sup>506</sup> (2) the amount of support received by one or more of the publicly supported organizations is sufficient to insure the attentiveness of the organization or organizations to the operations of the supporting organization (this is known as the “attentiveness requirement”);<sup>507</sup> and (3) a significant amount of the total support of the supporting organization goes to those publicly supported organizations that meet the attentiveness requirement.<sup>508</sup>

### **Charitable contributions**

Contributions to organizations described in section 501(c)(3) are deductible, subject to certain limitations, as an itemized deduction from Federal income taxes.<sup>509</sup> Such contributions also generally are deductible for estate and gift tax purposes.<sup>510</sup> However, if the taxpayer retains control over the assets transferred to charity, the transfer may not qualify as a completed gift for purposes of claiming an income, estate, or gift tax deduction.

Public charities enjoy certain advantages over private foundations regarding the deductibility of contributions. For example, contributions of appreciated capital gain property to

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<sup>505</sup> Treas. Reg. sec. 1.509(a)-4(i)(3)(ii).

<sup>506</sup> For this purpose, the IRS has defined the term “substantially all” of an organization's income to mean 85 percent or more. Rev. Rul. 76-208, 1976-1 C.B. 161.

<sup>507</sup> Although the regulations do not specify the requisite level of support in numerical or percentage terms, the IRS has suggested that grants that represent less than 10 percent of the beneficiary's support likely would be viewed as insufficient to ensure attentiveness. Gen. Couns. Mem. 36379 (August 15, 1975). As an alternative to satisfying the attentiveness standard by the foregoing method, a supporting organization may demonstrate attentiveness by showing that, in order to avoid the interruption of the carrying on of a particular function or activity, the beneficiary organization will be sufficiently attentive to the operations of the supporting organization. Treas. Reg. sec. 1.509(a)-4(i)(3)(iii)(b).

<sup>508</sup> Treas. Reg. sec. 1.509(a)-4(i)(3)(iii).

<sup>509</sup> Sec. 170.

<sup>510</sup> Secs. 2055 and 2522.

a private foundation generally are deductible only to the extent of the donor's cost basis.<sup>511</sup> In contrast, contributions to public charities generally are deductible in an amount equal to the property's fair market value, except for gifts of inventory and other ordinary income property, short-term capital gain property, and tangible personal property the use of which is unrelated to the donee organization's exempt purpose. In addition, under present law, a taxpayer's deductible contributions generally are limited to specified percentages of the taxpayer's contribution base, which generally is the taxpayer's adjusted gross income for a taxable year. The applicable percentage limitations vary depending upon the type of property contributed and the classification of the donee organization. In general, contributions to non-operating private foundations are limited to a smaller percentage of the donor's contribution base (up to 30 percent) than contributions to public charities (up to 50 percent).<sup>512</sup>

In general, taxpayers who make contributions and claim a charitable deduction must satisfy recordkeeping and substantiation requirements.<sup>513</sup> The requirements vary depending on the type and value of property contributed. A deduction generally may be denied if the donor fails to satisfy applicable recordkeeping or substantiation requirements.

### **Intermediate sanctions (excess benefit transaction tax)**

The Code imposes excise taxes on excess benefit transactions between disqualified persons and public charities.<sup>514</sup> An excess benefit transaction generally is a transaction in which an economic benefit is provided by a public charity directly or indirectly to or for the use of a disqualified person, if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit.

For purposes of the excess benefit transaction rules, a disqualified person is any person in a position to exercise substantial influence over the affairs of the public charity at any time in the five-year period ending on the date of the transaction at issue.<sup>515</sup> Persons holding certain powers, responsibilities, or interests (e.g., officers, directors, or trustees) are considered to be in a position to exercise substantial influence over the affairs of the public charity.

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<sup>511</sup> A special rule in section 170(e)(5) provides that taxpayer are allowed a deduction equal to the fair market value of certain contributions of appreciated, publicly traded stock contributed to a private foundation.

<sup>512</sup> Sec. 170(b).

<sup>513</sup> Sec. 170(f)(8).

<sup>514</sup> Sec. 4958. The excess benefit transaction tax is commonly referred to as "intermediate sanctions," because it imposes penalties generally considered to be less punitive than revocation of the organization's exempt status. The tax also applies to transactions between disqualified persons and social welfare organizations (as described in section 501(c)(4)).

<sup>515</sup> Sec. 4958(f)(1). A disqualified person also includes certain family members of such a person, and certain entities that satisfy a control test with respect to such persons.

An excess benefit transaction tax is imposed on the disqualified person and, in certain cases, on the organization managers, but is not imposed on the public charity. An initial tax of 25 percent of the excess benefit amount is imposed on the disqualified person that receives the excess benefit. An additional tax on the disqualified person of 200 percent of the excess benefit applies if the violation is not corrected within a specified period. A tax of 10 percent of the excess benefit (not to exceed \$10,000 with respect to any excess benefit transaction) is imposed on an organization manager that knowingly participated in the excess benefit transaction, if the manager's participation was willful and not due to reasonable cause, and if the initial tax was imposed on the disqualified person.

### **Community foundations**

Community foundations generally are broadly supported section 501(c)(3) public charities that make grants to other charitable organizations located within a community foundation's particular geographic area. Donors sometimes make contributions to a community foundation through transfers to a separate trust or fund, the assets of which are held and managed by a bank or investment company.

Certain community foundations are subject to special rules that permit them to treat the separate funds or trusts maintained by the community foundation as a single entity for tax purposes. This "single entity" status allows the community foundation to be classified as a public charity. One of the requirements that community foundations must meet is that funds maintained by the community foundation may not be subject by the donor to any material restrictions or conditions. The prohibition against material restrictions or conditions is designed to prevent a donor from encumbering a fund in a manner that prevents the community foundation from freely distributing the assets and income from it in furtherance of the community foundation's charitable purposes. Under Treasury regulations, whether a particular restriction or condition placed by the donor on the transfer of assets is material must be determined from all of the facts and circumstances of the transfer. The regulations set out some of the more significant facts and circumstances to be considered in making a determination, including: (1) whether the transferee public charity is the fee owner of the assets received; (2) whether the assets are held and administered by the public charity in a manner consistent with its own exempt purposes; (3) whether the governing body of the public charity has the ultimate authority and control over the assets and the income derived from them; and (4) whether the governing body of the public charity is independent from the donor. The regulations provide several non-adverse factors for determining whether a particular restriction or condition placed by the donor on the transfer of assets is material. In addition, the regulations list numerous factors and subfactors that indicate that the community foundation is prevented from freely and effectively employing the donated assets and the income thereon.

### **Donor advised funds**

Some charitable organizations (including community foundations) establish accounts to which donors may contribute and thereafter provide nonbinding advice or recommendations with regard to distributions from the fund or the investment of assets in the fund. Such accounts are commonly referred to as "donor advised funds." Donors who make contributions to charities for maintenance in a donor advised fund generally claim a charitable contribution deduction at the

time of the contribution. Although sponsoring charities frequently permit donors (or other persons appointed by donors) to provide nonbinding recommendations concerning the distribution or investment of assets in a donor advised fund, sponsoring charities generally must have legal ownership and control of such assets following the contribution. If the sponsoring charity does not have such control (or permits a donor to exercise control over amounts contributed), the donor's contributions may not qualify for a charitable deduction, and, in the case of a community foundation, the contribution may be treated as being subject to a material restriction or condition by the donor.

In recent years, a number of financial institutions have formed charitable corporations for the principal purpose of offering donor advised funds, sometimes referred to as "commercial" donor advised funds. In addition, some established charities have begun operating donor advised funds in addition to their primary activities. The IRS has recognized several organizations that sponsor donor advised funds, including "commercial" donor advised funds, as section 501(c)(3) public charities. The term "donor advised fund" is not defined in statute or regulations.

Under the Katrina Emergency Tax Relief Act of 2005, certain of the above-described percent limitations on contributions to public charities are temporarily suspended for purposes of certain "qualified contributions" to public charities. Under the Act, qualified contributions do not include a contribution if the contribution is for establishment of a new, or maintenance in an existing, segregated fund or account with respect to which the donor (or any person appointed or designated by such donor) has, or reasonably expects to have, advisory privileges with respect to distributions or investments by reason of the donor's status as a donor.

### **Excess business holdings of private foundations**

Private foundations are subject to tax on excess business holdings.<sup>516</sup> In general, a private foundation is permitted to hold 20 percent of the voting stock in a corporation, reduced by the amount of voting stock held by all disqualified persons (as defined in section 4946). If it is established that no disqualified person has effective control of the corporation, a private foundation and disqualified persons together may own up to 35 percent of the voting stock of a corporation. A private foundation shall not be treated as having excess business holdings in any corporation if it owns (together with certain other related private foundations) not more than two percent of the voting stock and not more than two percent in value of all outstanding shares of all classes of stock in that corporation. Similar rules apply with respect to holdings in a partnership ("profits interest" is substituted for "voting stock" and "capital interest" for "nonvoting stock") and to other unincorporated enterprises (by substituting "beneficial interest" for "voting stock"). Private foundations are not permitted to have holdings in a proprietorship. Foundations generally have a five-year period to dispose of excess business holdings (acquired other than by purchase) without being subject to tax.<sup>517</sup> This five-year period may be extended an additional five years in limited circumstances.<sup>518</sup> The excess business holdings rules do not apply to

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<sup>516</sup> Sec. 4943. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

<sup>517</sup> Sec. 4943(c)(6).

<sup>518</sup> Sec. 4943(c)(7).

holdings in a functionally related business or to holdings in a trade or business at least 95 percent of the gross income of which is derived from passive sources.<sup>519</sup>

The initial tax is equal to five percent of the value of the excess business holdings held during the foundation's applicable taxable year. An additional tax is imposed if an initial tax is imposed and at the close of the applicable taxable period, the foundation continues to hold excess business holdings. The amount of the additional tax is equal to 200 percent of such holdings.

### **Explanation of Provision**

#### **Definition of a donor advised fund**

##### General rule

In general, the provision defines a “donor advised fund” as a fund or account that is: (1) separately identified by reference to contributions of a donor or donors (2) owned and controlled by a sponsoring organization and (3) with respect to which a donor (or any person appointed or designated by such donor (a “donor advisor”) has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in the separately identified fund or account by reason of the donor's status as a donor. All three prongs of the definition must be met in order for a fund or account to be treated as a donor advised fund.

The provision defines a “sponsoring organization” as an organization that: (1) is described in section 170(c)<sup>520</sup> (other than a governmental entity described in section 170(c)(1), and without regard to any requirement that the organization be organized in the United States<sup>521</sup>); (2) is not a private foundation (as defined in section 509(a)); and (3) maintains one or more donor advised funds.

The first prong of the definition requires that a donor advised fund be separately identified by reference to contributions of a donor or donors. A distinct fund or account of a sponsoring organization does not meet this prong of the definition unless the fund or account refers to contributions of a donor or donors, such as by naming the fund after a donor, or by treating a fund on the books of the sponsoring organization as attributable to funds contributed by a specific donor or donors. Although a sponsoring organization's general fund is a “fund or account,” such fund will not, as a general matter, be treated as a donor advised fund because the general funds of an organization typically are not separately identified by reference to contributions of a specific donor or donors; rather contributions are pooled anonymously within the general fund. Similarly, a fund or account of a sponsoring organization that is distinct from the organization's general fund and that pools contributions of multiple donors generally will not

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<sup>519</sup> Sec. 4943(d)(3).

<sup>520</sup> Section 170(c) describes organizations to which charitable contributions that are deductible for income tax purposes can be made.

<sup>521</sup> See sec. 170(c)(2)(A).

meet the first prong of the definition unless the contributions of specific donors are in some manner tracked and accounted for within the fund. Accordingly, if a sponsoring organization establishes a fund dedicated to the relief of poverty within a specific community, or a scholarship fund, and the fund attracts contributions from several donors but does not separately identify or refer to contributions of a donor or donors, the fund is not a donor advised fund even if a donor has advisory privileges with respect to the fund. However, a fund or account may not avoid treatment as a donor advised fund even though there is no formal recognition of such separate contributions on the books of the sponsoring organization if the fund or account operates as if contributions of a donor or donors are separately identified. The Secretary has the authority to look to the substance of an arrangement, and not merely its form. In addition, a fund or account may be treated as identified by reference to contributions of a donor or donors if the reference is to persons related to a donor. For example, if a husband made contributions to a fund or account that in turn is named after the husband's wife, the fund is treated as being separately identified by reference to contributions of a donor.

The second prong of the definition provides that the fund be owned and controlled by a sponsoring organization. To the extent that a donor or person other than the sponsoring organization owns or controls amounts deposited to a sponsoring organization, a fund or account is not a donor advised fund. (In cases where a donor retains control of an amount provided to a sponsoring organization, there may not be a completed gift for purposes of the charitable contribution deduction.)

The third prong of the definition provides that with respect to a fund or account of a sponsoring organization, a donor or donor advisor has or reasonably expects to have advisory privileges with respect to the distribution or investment of amounts held in the fund or account by reason of a donor's status as a donor. Advisory privileges are distinct from a legal right or obligation. For example, if a donor executes a gift agreement with a sponsoring organization that specifies certain enforceable rights of the donor with respect to a gift, the donor will not be treated as having "advisory privileges" due to such enforceable rights for purposes of the donor advised fund definition.

The presence of an advisory privilege may be evident through a written document that describes an arrangement between the donor or donor adviser and the sponsoring organization whereby a donor or donor adviser may provide advice to the sponsoring organization about the investment or distribution of amounts held by a sponsoring organization, even if such privileges are not exercised. The presence of an advisory privilege also may be evident through the conduct of a donor or donor adviser and the sponsoring organization. For example, even in the absence of a writing, if a donor regularly provides advice to a sponsoring organization and the sponsoring organization regularly considers such advice, the donor has advisory privileges under the provision. Even if advisory privileges do not exist at the time of a contribution, later acts by the donor (through the provision of advice) and by the sponsoring organization (through the regular consideration of advice) may establish advisory privileges subsequent to the time of the contribution. For example, if a past donor of \$100,000 telephones a sponsoring organization and states that he would like the sponsoring organization to distribute \$10,000 to an organization described in section 170(b)(1)(A), although the mere act of providing advice does not establish an advisory privilege, if the sponsoring organization distributed the \$10,000 to the organization specified by the donor in consideration of the donor's advice, and reinforced the donor in some

manner that future advice similarly would be considered, advisory privileges (or the reasonable expectation thereof) might be established. However, the mere provision of advice by a donor or donor advisor does not mean the donor or donor advisor has advisory privileges. For example, a donor's singular belief that he or she has advisory privileges with respect to the contribution does not establish an advisory privilege – there must be some reciprocity on the part of the sponsoring organization.

A person reasonably expects to have advisory privileges if both the donor or donor advisor and the sponsoring organization have reason to believe that the donor or donor advisor will provide advice and that the sponsoring organization generally will consider it. Thus, a person reasonably may expect to have advisory privileges even in the absence of the actual provision of advice. However, a donor's expectation of advisory privileges is not reasonable unless it is reinforced in some manner by the conduct of the sponsoring organization. If, at the time of the contribution, the sponsoring organization had no knowledge that the donor had an expectation of advisory privileges, or no intention of considering any advice provided by the donor, then the donor does not have a reasonable expectation of advisory privileges. Ultimately, the presence or absence of advisory privileges (or a reasonable expectation thereof) depends upon the facts and circumstances, which in turn depend upon the conduct (including any agreement) of both the donor or donor advisor and the sponsoring organization with respect to the making and consideration of advice.

A further requirement of the third prong is that the reasonable expectation of advisory privileges is by reason of the donor's status as a donor. Under this requirement, if a donor's reasonable expectation of advisory privileges is due solely to the donor's service to the organization, for example, by reason of the donor's position as an officer, employee, or director of the sponsoring organization, then the third prong of the definition is not satisfied. For instance, in general, a donor that is a member of the board of directors of the sponsoring organization may provide advice in his or her capacity as a board member with respect to the distribution or investment of amounts in a fund to which the board member contributed. However, if by reason of such donor's contribution to such fund, the donor secured an appointment on a committee of the sponsoring organization that advises how to distribute or invest amounts in such fund, the donor may have a reasonable expectation of advisory privileges, notwithstanding that the donor is an officer, employee, or director of the sponsoring organization.

The third prong of the definition is applicable to a donor or any person appointed or designated by such donor (the donor advisor). For purposes of this prong, a person appointed or designated by a donor advisor is treated as being appointed or designated by a donor. In addition, for purposes of any exception to the definition of a donor advised fund provided under the provision, to the extent a donor recommends to a sponsoring organization the selection of members of a committee that will advise as to distributions or investments of amounts in a fund or account of such sponsoring organization, such members are not treated as appointed or designated by the donor if the recommendation of such members by such donor is based on objective criteria related to the expertise of the member. For example, if a donor recommends that a committee of a sponsoring organization that will provide advice regarding scholarship grants for the advancement of science at local secondary schools should consist of persons who are the heads of the science departments of such schools, then the donor generally would not be

considered to have appointed or designated such persons, i.e., they would not be treated as donor advisors.

### Exceptions

A donor advised fund does not include a fund or account that makes distributions only to a single identified organization or governmental entity. For example, an endowment fund owned and controlled by a sponsoring organization that is held exclusively to for the benefit of such sponsoring organization is not a donor advised fund even if the fund is named after its principal donor and such donor has advisory privileges with respect to the distribution of amounts held in the fund to such sponsoring organization. Accordingly, a donor that contributes to a university for purposes of establishing a fund named after the donor that exclusively supports the activities of the university is not a donor advised fund even if the donor has advisory privileges regarding the distribution or investment of amounts in the fund.

A donor advised fund also does not include a fund or account with respect to which a donor or donor advisor provides advice as to which individuals receive grants for travel, study, or other similar purposes, provided that (1) the donor's or donor advisor's advisory privileges are performed exclusively by such donor or donor advisor in such person's capacity as a member of a committee all of the members of which are appointed by the sponsoring organization, (2) no combination of a donor or donor advisor or persons related to such persons, control, directly or indirectly, such committee, and (3) all grants from such fund or account are awarded on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the board of directors of the sponsoring organization, and such procedure is designed to ensure that all such grants meet the requirements described in paragraphs (1), (2), or (3) of section 4945(g) (concerning grants to individuals by private foundations).

In addition, the Secretary may exempt a fund or account from treatment as a donor advised fund if such fund or account is advised by a committee not directly or indirectly controlled by a donor, donor advisor, or persons related to a donor or donor advisor. For such purposes, it is intended that indirect control includes the ability to exercise effective control. For example, if a donor, a donor advisor, and an attorney hired by the donor to provide advice regarding the donor's contributions constitute three of the five members of such a committee, the committee would be treated as being controlled indirectly by the donor for purposes of such an exception. Board membership alone does not establish direct or indirect control. In general, under this authority, the Secretary may establish rules regarding committee advised funds generally that, if followed, would result in the fund not being treated as a donor advised fund. The Secretary also may establish rules excepting certain types of committee-advised funds, such as a fund established exclusively for disaster relief, from the donor advised fund definition.

The provision also provides that the Secretary may exempt a fund or account from treatment as a donor advised fund if such fund or account benefits a single identified charitable purpose.

## **Deductibility of contributions to a sponsoring organization for maintenance in a donor advised fund**

### **Contributions to certain sponsoring organizations for maintenance in a donor advised fund not eligible for a charitable deduction**

Under the provision, contributions to a sponsoring organization for maintenance in a donor advised fund are not eligible for a charitable deduction for income tax purposes if the sponsoring organization is a veterans' organization described in section 170(c)(3), a fraternal society described in section 170(c)(4), or a cemetery company described in section 170(c)(5); for gift tax purposes if the sponsoring organization is a fraternal society described in section 2522(a)(3) or a veterans' organization described in section 2522(a)(4); or for estate tax purposes if the sponsoring organization is a fraternal society described in section 2055(a)(3) or a veterans' organization described in section 2055(a)(4). In addition, contributions to a sponsoring organization for maintenance in a donor advised fund are not eligible for a charitable deduction for income, gift, or estate tax purposes if the sponsoring organization is a Type III supporting organization (other than a functionally integrated Type III supporting organization). A functionally integrated Type III supporting organization is a Type III supporting organization that is not required under regulations established by the Secretary to make payments to supported organizations due to the activities of the organization related to performing the functions of, or carrying out the purposes of, such supported organizations.<sup>522</sup>

### **Additional substantiation requirements**

In addition to satisfying present-law substantiation requirements under section 170(f), a donor must obtain, with respect to each charitable contribution to a sponsoring organization to be maintained in a donor advised fund, a contemporaneous written acknowledgment from the sponsoring organization providing that the sponsoring organization has exclusive legal control over the assets contributed.

### **Excess business holdings**

The excess business holdings rules of section 4943 are applied to donor advised funds. In applying such rules, the term disqualified person means, with respect to a donor advised fund, a donor, donor advisor, a member of the family of a donor or donor advisor, or a 35 percent controlled entity of any such person. Transition rules apply to the present holdings of a donor advised fund similar to those of section 4943(c)(4)-(6).

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<sup>522</sup> The current such regulation is Treasury regulation section 1.509(a)-4(i)(3)(ii).

## **Automatic excess benefit transactions, disqualified persons, taxable distributions, and more than incidental benefit**

### Automatic excess benefit transactions

Under the provision, any grant, loan, compensation, or other similar payment from a donor advised fund to a person that with respect to such fund is a donor, donor advisor, or a person related<sup>523</sup> to a donor or donor advisor automatically is treated as an excess benefit transaction under section 4958, with the entire amount<sup>524</sup> paid to any such person treated as the amount of the excess benefit. Other similar payments include payments in the nature of a grant, loan, or payment of compensation, such as an expense reimbursement. Other similar payments do not include, for example, a payment pursuant to bona fide sale or lease of property, which instead are subject to the general rules of section 4958 under the special disqualified person rule of the provision described below. Also as described below, payment by a sponsoring organization of, for example, compensation to a person who both is a donor with respect to a donor advised fund of the sponsoring organization and a service provider with respect to the sponsoring organization generally, will not be subject to the automatic excess benefit transaction rule of the provision unless the payment (of a grant, loan, compensation, or other similar payment) properly is viewed as a payment from the donor advised fund and not from the sponsoring organization.

Any amount repaid as a result of correcting an excess benefit transaction shall not be held in any donor advised fund.

### Disqualified persons

In general, the provision provides that donors and donor advisors with respect to a donor advised fund (as well as persons related to a donor or donor advisor) are treated as disqualified persons under section 4958 with respect to transactions with such donor advised fund (though not necessarily with respect to transactions with the sponsoring organization more generally). For example, if a donor to a donor advised fund purchased securities from the fund, the purchase is subject to the rules of section 4958 because, under the provision, the donor is a disqualified person with respect to the fund. Thus, if as a result of the purchase, the donor receives an excess benefit as defined under generally applicable section 4958 rules, then the donor is subject to tax under such rules. If, as generally would be the case, the purchase was of securities that were contributed by the donor, a factor that may indicate the presence of an excess benefit is if the amount paid by the donor to acquire the securities is less than the amount the donor claimed the

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<sup>523</sup> For purposes of the provision, a person is treated as related to another person if (1) such person bears a relationship to such other person similar to the relationships described in sections 4958(f)(1)(B) and 4958(f)(1)(C).

<sup>524</sup> The requirement of the provision that the entire amount of the payment be treated as the amount of the excess benefit differs from the generally applicable rule of section 4958, which provides that the excess benefit is the amount by which the value of the economic benefit provided exceeds the value of the consideration received.

securities were worth for purposes of any charitable contribution deduction of the donor. In addition, if a donor advised fund distributes securities to the sponsoring organization of the fund prior to purchase by the donor, consideration should be given to whether the distribution to the sponsoring organization prior to the purchase was intended to circumvent the disqualified person rule of the provision. If so, such a distribution may be disregarded with the result that the purchase is treated as being made from the donor advised fund and not from the sponsoring organization.

As a factual matter, a person who is a donor to a donor advised fund and thus a disqualified person with respect to the fund also may be a service provider with respect to the sponsoring organization. In general, under the provision, as under present law, the sponsoring organization's transactions with the service provider are not subject to the rules of section 4958 unless the service provider is a disqualified person with respect to the sponsoring organization (e.g., if the service provider serves on the board of directors of the sponsoring organization), or unless the transaction is not properly viewed as a transaction with the sponsoring organization but in substance is a transaction with the service provider's donor advised fund. If the transaction properly is viewed as a transaction with the donor advised fund of a sponsoring organization, then the transaction is subject to the rules of section 4958, and, as described above, if the transaction involves payment of a grant, loan, compensation, or other similar payment, then the transaction is subject to the special automatic excess benefit transaction rule of the provision. For example, if a sponsoring organization pays an amount as part of a service contract to a service provider (a bank, for example) who also is a donor to a donor advised fund of the sponsoring organization, and such amounts reasonably are charged uniformly in whole or in part as routine fees to all of the sponsoring organization's donor advised funds, the transaction generally is considered to be between the sponsoring organization and the service provider in such service provider's capacity as a service provider. The transaction is not considered to be a transaction between a donor advised fund and the service provider even though an amount paid under the contract was charged to a donor advised fund of the service provider.

The provision provides that an investment advisor (as well as persons related to the investment advisor) is treated as a disqualified person under section 4958 with respect to the sponsoring organization. Under the provision, the term "investment advisor" means, with respect to any sponsoring organization, any person (other than an employee of the sponsoring organization) compensated by the sponsoring organization for managing the investment of, or providing investment advice with respect to, assets maintained in donor advised funds (including pools of assets all or part of which are attributed to donor advised funds) owned by the sponsoring organization.

### Taxable distributions

Under the provision, certain distributions from a donor advised fund are subject to tax. A "taxable distribution" is any distribution from a donor advised fund to (1) any natural person;<sup>525</sup>

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<sup>525</sup> Under the provision, the term disqualified supporting organization means, with respect to any distribution from a donor advised fund: (1) a Type III supporting organization, other than a functionally integrated Type III supporting organization; and (2) any other supporting organization if either (a) the

(2) to any other person for any purpose other than one specified in section 170(c)(2)(B) (generally, a charitable purpose) or, if for a charitable purpose, the sponsoring organization does not exercise expenditure responsibility with respect to the distribution in accordance with section 4945(h). The expenditure responsibility rules generally require that an organization exert all reasonable efforts and establish adequate procedures to see that the distribution is spent solely for the purposes for which made, to obtain full and complete reports from the distributee on how the funds are spent, and to make full and detailed reports with respect to such expenditures to the Secretary. A taxable distribution does not in any case include a distribution to (1) an organization described in section 170(b)(1)(A)<sup>526</sup> (other than to a disqualified supporting organization); (2) the sponsoring organization of such donor advised fund; or (3) to another donor advised fund.<sup>527</sup>

In the event of a taxable distribution, an excise tax equal to 20 percent of the amount of the distribution is imposed against the sponsoring organization. In addition, an excise tax equal to five percent of the amount of the distribution is imposed against any manager of the sponsoring organization (defined in a manner similar to the term “foundation manager” under section 4945) who knowingly approved the distribution, not to exceed \$10,000 with respect to any one taxable distribution. The taxes on taxable distributions are subject to abatement under generally applicable present law rules.

#### More than incidental benefit

Under the provision, if a donor, a donor advisor, or a person related to a donor or donor advisor of a donor advised fund provides advice as to a distribution that results in any such person receiving, directly or indirectly, a more than incidental benefit, an excise tax equal to 125 percent of the amount of such benefit is imposed against the person who advised as to the

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donor or donor advisor of the distributing donor advised fund directly or indirectly controls a supported organization of the supporting organization, or (b) the Secretary determines by regulations that a distribution to such supporting organization otherwise is inappropriate.

<sup>526</sup> For purposes of the requirement that a distribution be “to” an organization described in section 170(b)(1)(A), in general, it is intended that rules similar to the rules of Treasury regulation section 53.4945-5(a)(5) apply. Under such regulations, for purposes of determining whether a grant by a private foundation is “to” an organization described in section 509(a)(1), (2), or (3) and so not a taxable expenditure under section 4945, a foreign organization that otherwise is not a section 509(a)(1), (2), or (3) organization is considered as such if the private foundation makes a good faith determination that the grantee is such an organization. Similarly, under the provision, if a sponsoring organization makes a good faith determination (under standards similar to those currently applicable for private foundations) that a distributee organization is an organization described in section 170(b)(1)(A) (other than a disqualified supporting organization), then a distribution to such organization is not considered a taxable distribution.

<sup>527</sup> Under the provision, sponsoring organizations may make grants to natural persons from amounts not held in donor advised funds and may establish scholarship funds that are not donor advised funds. A donor may choose to make a contribution directly to such a scholarship fund (or advise that a donor advised fund make a distribution to such a scholarship fund).

distribution, and against the recipient of the benefit. Persons subject to the tax are jointly and severally liable for the tax. In addition, if a manager of the sponsoring organization (defined in a manner similar to the term “foundation manager” under section 4945) agreed to the making of the distribution, knowing that the distribution would confer a more than incidental benefit on a donor, a donor advisor, or a person related to a donor or donor advisor, the manager is subject to an excise tax equal to 10 percent of the amount of such benefit, not to exceed \$10,000. The taxes on more than incidental benefit are subject to abatement under generally applicable present law rules.

In general, under the provision, there is a more than incidental benefit if, as a result of a distribution from a donor advised fund, a donor, donor advisor, or related person with respect to such fund receives a benefit that would have reduced (or eliminated) a charitable contribution deduction if the benefit was received as part of the contribution to the sponsoring organization. If, for example, a donor advises a that a distribution from the donor’s donor advised fund be made to the Girl Scouts of America, and the donor’s daughter is a member of a local unit of the Girl Scouts of America, the indirect benefit the donor receives as a result of such contribution is considered incidental under the provision, as it generally would not have reduced or eliminated the donor’s deduction if it had been received as part of a contribution by donor to the sponsoring organization.<sup>528</sup>

### **Reporting and disclosure**

The provision requires each sponsoring organization to disclose on its information return: (1) the total number of donor advised funds it owns; (2) the aggregate value of assets held in those funds at the end of the organization’s taxable year; and (3) the aggregate contributions to and grants made from those funds during the year.

In addition, when seeking recognition of its tax-exempt status, a sponsoring organization must disclose whether it intends to maintain donor advised funds. It is intended that the organization must provide information regarding its planned operation of such funds, including, for example, a description of procedures it intends to use to: (1) communicate to donors and donor advisors that assets held in donor advised funds are the property of the sponsoring organization; and (2) ensure that distributions from donor advised funds do not result in more than incidental benefit to any person.

### **Effective Date**

The provision generally is effective for taxable years beginning after the date of enactment. The provision relating to excess benefit transactions is effective for transactions occurring after the date of enactment. Information return requirements are effective for taxable years ending after the date of enactment. The requirements concerning disclosures on an organization’s application for tax exemption are effective for organizations applying for recognition of exempt status after the date of enactment. Requirements relating to charitable

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<sup>528</sup> See, e.g., Rev. Rul. 80-77, 1980-1 C.B. 56; Rev. Proc. 90-12, 1990-1 C.B. 471.

contributions to donor advised funds are effective for contributions made after 180 days from the date of enactment.

## **18. Improve accountability of supporting organizations (secs. 509, 4942, 4943, 4945, 4958, and 6033 of the Code)**

### **Present Law**

#### **Requirements for section 501(c)(3) tax-exempt status**

Charitable organizations, i.e., organizations described in section 501(c)(3), generally are exempt from Federal income tax and are eligible to receive tax deductible contributions. A charitable organization must operate primarily in pursuance of one or more tax-exempt purposes constituting the basis of its tax exemption.<sup>529</sup> In order to qualify as operating primarily for a purpose described in section 501(c)(3), an organization must satisfy the following operational requirements: (1) the net earnings of the organization may not inure to the benefit of any person in a position to influence the activities of the organization; (2) the organization must operate to provide a public benefit, not a private benefit;<sup>530</sup> (3) the organization may not be operated primarily to conduct an unrelated trade or business;<sup>531</sup> (4) the organization may not engage in substantial legislative lobbying; and (5) the organization may not participate or intervene in any political campaign.

Section 501(c)(3) organizations (with certain exceptions) are required to seek formal recognition of tax-exempt status by filing an application with the IRS (Form 1023). In response to the application, the IRS issues a determination letter or ruling either recognizing the applicant as tax-exempt or not.

In general, organizations exempt from Federal income tax under section 501(a) are required to file an annual information return with the IRS.<sup>532</sup> Under present law, the information return requirement does not apply to several categories of exempt organizations. Organizations

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<sup>529</sup> Treas. Reg. sec. 1.501(c)(3)-1(c)(1). The Code specifies such purposes as religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster international amateur sports competition, or for the prevention of cruelty to children or animals. In general, an organization is organized and operated for charitable purposes if it provides relief for the poor and distressed or the underprivileged. Treas. Reg. sec. 1.501(c)(3)-1(d)(2).

<sup>530</sup> Treas. Reg. sec. 1.501(c)(3)-1(d)(1)(ii).

<sup>531</sup> Treas. Reg. sec. 1.501(c)(3)-1(e)(1). Conducting a certain level of unrelated trade or business activity will not jeopardize tax-exempt status.

<sup>532</sup> Sec. 6033(a)(1).

exempt from the filing requirement include organizations (other than private foundations), the gross receipts of which in each taxable year normally are not more than \$25,000.<sup>533</sup>

### **Classification of section 501(c)(3) organizations**

#### **In general**

Section 501(c)(3) organizations are classified either as “public charities” or “private foundations.”<sup>534</sup> Private foundations generally are defined under section 509(a) as all organizations described in section 501(c)(3) other than an organization granted public charity status by reason of: (1) being a specified type of organization (i.e., churches, educational institutions, hospitals and certain other medical organizations, certain organizations providing assistance to colleges and universities, or a governmental unit); (2) receiving a substantial part of its support from governmental units or direct or indirect contributions from the general public; or (3) providing support to another section 501(c)(3) entity that is not a private foundation. In contrast to public charities, private foundations generally are funded from a limited number of sources (e.g., an individual, family, or corporation). Donors to private foundations and persons related to such donors together often control the operations of private foundations.

Because private foundations receive support from, and typically are controlled by, a small number of supporters, private foundations are subject to a number of anti-abuse rules and excise taxes not applicable to public charities.<sup>535</sup> For example, the Code imposes excise taxes on acts of “self-dealing” between disqualified persons (generally, an enumerated class of foundation insiders<sup>536</sup>) and a private foundation. Acts of self-dealing include, for example, sales or exchanges, or leasing, of property; lending of money; or the furnishing of goods, services, or facilities between a disqualified person and a private foundation.<sup>537</sup> In addition, private non-operating foundations are required to pay out a minimum amount each year as qualifying distributions. In general, a qualifying distribution is an amount paid to accomplish one or more of the organization’s exempt purposes, including reasonable and necessary administrative

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<sup>533</sup> Sec. 6033(a)(2); Treas. Reg. sec. 1.6033-2(a)(2)(i); Treas. Reg. sec. 1.6033-2(g)(1). Sec. 6033(a)(2)(A)(ii) provides a \$5,000 annual gross receipts exception from the annual reporting requirements for certain exempt organizations. In Announcement 82-88, 1982-25 I.R.B. 23, the IRS exercised its discretionary authority under section 6033 to increase the gross receipts exception to \$25,000, and enlarge the category of exempt organizations that are not required to file Form 990.

<sup>534</sup> Sec. 509(a). Private foundations are either private operating foundations or private non-operating foundations. In general, private operating foundations operate their own charitable programs in contrast to private non-operating foundations, which generally are grant-making organizations. Most private foundations are non-operating foundations.

<sup>535</sup> Secs. 4940 - 4945.

<sup>536</sup> See sec. 4946(a).

<sup>537</sup> Sec. 4941.

expenses.<sup>538</sup> Certain expenditures of private foundations are also subject to tax.<sup>539</sup> In general, taxable expenditures are expenditures: (1) for lobbying; (2) to influence the outcome of a public election or carry on a voter registration drive (unless certain requirements are met); (3) as a grant to an individual for travel, study, or similar purposes unless made pursuant to procedures approved by the Secretary; (4) as a grant to an organization that is not a public charity or exempt operating foundation unless the foundation exercises expenditure responsibility<sup>540</sup> with respect to the grant; or (5) for any non-charitable purpose. Additional excise taxes may apply in the event a private foundation holds certain business interests (“excess business holdings”)<sup>541</sup> or makes an investment that jeopardizes the foundation’s exempt purposes.<sup>542</sup>

Public charities also enjoy certain advantages over private foundations regarding the deductibility of contributions. For example, contributions of appreciated capital gain property to a private foundation generally are deductible only to the extent of the donor’s cost basis.<sup>543</sup> In contrast, contributions to public charities generally are deductible in an amount equal to the property’s fair market value, except for gifts of inventory and other ordinary income property, short-term capital gain property, and tangible personal property the use of which is unrelated to the donee organization’s exempt purpose. In addition, under present law, a taxpayer’s deductible contributions generally are limited to specified percentages of the taxpayer’s contribution base, which generally is the taxpayer’s adjusted gross income for a taxable year. The applicable percentage limitations vary depending upon the type of property contributed and the classification of the donee organization. In general, contributions to non-operating private foundations are limited to a smaller percentage of the donor’s contribution base (up to 30 percent) than contributions to public charities (up to 50 percent).<sup>544</sup>

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<sup>538</sup> Sec. 4942(g)(1)(A). A qualifying distribution also includes any amount paid to acquire an asset used (or held for use) directly in carrying out one or more of the organization’s exempt purposes and certain amounts set-aside for exempt purposes. Sec. 4942(g)(1)(B) and 4942(g)(2).

<sup>539</sup> Sec. 4945. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

<sup>540</sup> In general, expenditure responsibility requires that a foundation make all reasonable efforts and establish reasonable procedures to ensure that the grant is spent solely for the purpose for which it was made, to obtain reports from the grantee on the expenditure of the grant, and to make reports to the Secretary regarding such expenditures. Sec. 4945(h).

<sup>541</sup> Sec. 4943.

<sup>542</sup> Sec. 4944.

<sup>543</sup> A special rule in section 170(e)(5) provides that taxpayer are allowed a deduction equal to the fair market value of certain contributions of appreciated, publicly traded stock contributed to a private foundation.

<sup>544</sup> Sec. 170(b).

### Supporting organizations (section 509(a)(3))

The Code provides that certain “supporting organizations” (in general, organizations that provide support to another section 501(c)(3) organization that is not a private foundation) are classified as public charities rather than private foundations.<sup>545</sup> To qualify as a supporting organization, an organization must meet all three of the following tests: (1) it must be organized and at all times operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more “publicly supported organizations”<sup>546</sup> (the “organizational and operational tests”);<sup>547</sup> (2) it must be operated, supervised, or controlled by or in connection with one or more publicly supported organizations (the “relationship test”);<sup>548</sup> and (3) it must not be controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more publicly supported organizations (the “lack of outside control test”).<sup>549</sup>

To satisfy the relationship test, a supporting organization must hold one of three statutorily described close relationships with the supported organization. The organization must be: (1) operated, supervised, or controlled by a publicly supported organization (commonly referred to as “Type I” supporting organizations); (2) supervised or controlled in connection with a publicly supported organization (“Type II” supporting organizations); or (3) operated in connection with a publicly supported organization (“Type III” supporting organizations).<sup>550</sup>

#### Type I supporting organizations

In the case of supporting organizations that are operated, supervised, or controlled by one or more publicly supported organizations (Type I supporting organizations), one or more supported organizations must exercise a substantial degree of direction over the policies, programs, and activities of the supporting organization.<sup>551</sup> The relationship between the Type I supporting organization and the supported organization generally is comparable to that of a parent and subsidiary. The requisite relationship may be established by the fact that a majority of the officers, directors, or trustees of the supporting organization are appointed or elected by

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<sup>545</sup> Sec. 509(a)(3).

<sup>546</sup> In general, supported organizations of a supporting organization must be publicly supported charities described in sections 509(a)(1) or (a)(2).

<sup>547</sup> Sec. 509(a)(3)(A).

<sup>548</sup> Sec. 509(a)(3)(B).

<sup>549</sup> Sec. 509(a)(3)(C).

<sup>550</sup> Treas. Reg. sec. 1.509(a)-4(f)(2).

<sup>551</sup> Treas. Reg. sec. 1.509(a)-4(g)(1)(i).

the governing body, members of the governing body, officers acting in their official capacity, or the membership of one or more publicly supported organizations.<sup>552</sup>

### Type II supporting organizations

Type II supporting organizations are supervised or controlled in connection with one or more publicly supported organizations. Rather than the parent-subsidiary relationship characteristic of Type I organizations, the relationship between a Type II organization and its supported organizations is more analogous to a brother-sister relationship. In order to satisfy the Type II relationship requirement, generally there must be common supervision or control by the persons supervising or controlling both the supporting organization and the publicly supported organizations.<sup>553</sup> An organization generally is not considered to be “supervised or controlled in connection with” a publicly supported organization merely because the supporting organization makes payments to the publicly supported organization, even if the obligation to make payments is enforceable under state law.<sup>554</sup>

### Type III supporting organizations

Type III supporting organizations are “operated in connection with” one or more publicly supported organizations. To satisfy the “operated in connection with” relationship, Treasury regulations require that the supporting organization be responsive to, and significantly involved in the operations of, the publicly supported organization. This relationship is deemed to exist where the supporting organization meets both a “responsiveness test” and an “integral part test.”<sup>555</sup>

In general, the responsiveness test requires that the Type III supporting organization be responsive to the needs or demands of the publicly supported organizations. The responsiveness test may be satisfied in one of two ways.<sup>556</sup> First, the supporting organization may demonstrate that: (1)(a) one or more of its officers, directors, or trustees are elected or appointed by the officers, directors, trustees, or membership of the supported organization; (b) one or more members of the governing bodies of the publicly supported organizations are also officers, directors, or trustees of the supporting organization; or (c) the officers, directors, or trustees of the supporting organization maintain a close continuous working relationship with the officers,

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<sup>552</sup> Id.

<sup>553</sup> Treas. Reg. sec. 1.509(a)-4(h)(1).

<sup>554</sup> Treas. Reg. sec. 1.509(a)-4(h)(2).

<sup>555</sup> Treas. Reg. sec. 1.509(a)-4(i)(1).

<sup>556</sup> For an organization that was supporting or benefiting one or more publicly supported organizations before November 20, 1970, additional facts and circumstances, such as an historic and continuing relationship between organizations, also may be taken into consideration to establish compliance with either of the responsiveness tests. Treas. Reg. sec. 1.509(a)-4(i)(1)(ii).

directors, or trustees of the publicly supported organizations; and (2) by reason of such arrangement, the officers, directors, or trustees of the supported organization have a significant voice in the investment policies of the supporting organization, the timing and manner of making grants, the selection of grant recipients by the supporting organization, and otherwise directing the use of the income or assets of the supporting organization.<sup>557</sup> Alternatively, the responsiveness test may be satisfied if the supporting organization is a charitable trust under state law, each specified supported organization is a named beneficiary under the trust's governing instrument, and the beneficiary organization has the power to enforce the trust and compel an accounting under state law.<sup>558</sup>

In general, the integral part test requires that the Type III supporting organization maintain significant involvement in the operations of one or more publicly supported organizations, and that such publicly supported organizations are in turn dependent upon the supporting organization for the type of support which it provides. There are two alternative methods for satisfying the integral part test. The first alternative is to establish that (1) the activities engaged in for or on behalf of the publicly supported organization are activities to perform the functions of, or carry out the purposes of, such organizations; and (2) these activities, but for the involvement of the supporting organization, normally would be engaged in by the publicly supported organizations themselves.<sup>559</sup> Organizations that satisfy this “but for” test sometimes are referred to as “functionally integrated” Type III supporting organizations. The second method for satisfying the integral part test is to establish that: (1) the supporting organization pays substantially all of its income to or for the use of one or more publicly supported organizations;<sup>560</sup> (2) the amount of support received by one or more of the publicly supported organizations is sufficient to insure the attentiveness of the organization or organizations to the operations of the supporting organization (this is known as the “attentiveness requirement”);<sup>561</sup> and (3) a significant amount of the total support of the supporting organization goes to those publicly supported organizations that meet the “attentiveness requirement.”<sup>562</sup>

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<sup>557</sup> Treas. Reg. sec. 1.509(a)-4(i)(2)(ii).

<sup>558</sup> Treas. Reg. sec. 1.509(a)-4(i)(2)(iii).

<sup>559</sup> Treas. Reg. sec. 1.509(a)-4(i)(3)(ii).

<sup>560</sup> For this purpose, the IRS has defined the term “substantially all” of an organization's income to mean 85 percent or more. Rev. Rul. 76-208, 1976-1 C.B. 161.

<sup>561</sup> Although the regulations do not specify the requisite level of support in numerical or percentage terms, the IRS has suggested that grants that represent less than 10 percent of the beneficiary's support likely would be viewed as insufficient to ensure attentiveness. Gen. Couns. Mem. 36379 (August 15, 1975). As an alternative to satisfying the attentiveness standard by the foregoing method, a supporting organization may demonstrate attentiveness by showing that, in order to avoid the interruption of the carrying on of a particular function or activity, the beneficiary organization will be sufficiently attentive to the operations of the supporting organization. Treas. Reg. sec. 1.509(a)-4(i)(3)(iii)(b).

<sup>562</sup> Treas. Reg. sec. 1.509(a)-4(i)(3)(iii).

### **Intermediate sanctions (excess benefit transaction tax)**

The Code imposes excise taxes on excess benefit transactions between disqualified persons and public charities.<sup>563</sup> An excess benefit transaction generally is a transaction in which an economic benefit is provided by a public charity directly or indirectly to or for the use of a disqualified person, if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit.

For purposes of the excess benefit transaction rules, a disqualified person is any person in a position to exercise substantial influence over the affairs of the public charity at any time in the five-year period ending on the date of the transaction at issue.<sup>564</sup> Persons holding certain powers, responsibilities, or interests (e.g., officers, directors, or trustees) are considered to be in a position to exercise substantial influence over the affairs of the public charity.

An excess benefit transaction tax is imposed on the disqualified person and, in certain cases, on the organization managers, but is not imposed on the public charity. An initial tax of 25 percent of the excess benefit amount is imposed on the disqualified person that receives the excess benefit. An additional tax on the disqualified person of 200 percent of the excess benefit applies if the violation is not corrected within a specified period. A tax of 10 percent of the excess benefit (not to exceed \$10,000 with respect to any excess benefit transaction) is imposed on an organization manager that knowingly participated in the excess benefit transaction, if the manager's participation was willful and not due to reasonable cause, and if the initial tax was imposed on the disqualified person.

### **Excess business holdings of private foundations**

Private foundations are subject to tax on excess business holdings.<sup>565</sup> In general, a private foundation is permitted to hold 20 percent of the voting stock in a corporation, reduced by the amount of voting stock held by all disqualified persons (as defined in section 4946). If it is established that no disqualified person has effective control of the corporation, a private foundation and disqualified persons together may own up to 35 percent of the voting stock of a corporation. A private foundation shall not be treated as having excess business holdings in any corporation if it owns (together with certain other related private foundations) not more than two percent of the voting stock and not more than two percent in value of all outstanding shares of all classes of stock in that corporation. Similar rules apply with respect to holdings in a partnership ("profits interest" is substituted for "voting stock" and "capital interest" for "nonvoting stock") and to other unincorporated enterprises (by substituting "beneficial interest" for "voting stock").

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<sup>563</sup> Sec. 4958. The excess benefit transaction tax is commonly referred to as "intermediate sanctions," because it imposes penalties generally considered to be less punitive than revocation of the organization's exempt status. The tax also applies to transactions between disqualified persons and social welfare organizations (as described in section 501(c)(4)).

<sup>564</sup> Sec. 4958(f)(1). A disqualified person also includes certain family members of such a person, and certain entities that satisfy a control test with respect to such persons.

<sup>565</sup> Sec. 4943. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

Private foundations are not permitted to have holdings in a proprietorship. Foundations generally have a five-year period to dispose of excess business holdings (acquired other than by purchase) without being subject to tax.<sup>566</sup> This five-year period may be extended an additional five years in limited circumstances.<sup>567</sup> The excess business holdings rules do not apply to holdings in a functionally related business or to holdings in a trade or business at least 95 percent of the gross income of which is derived from passive sources.<sup>568</sup>

The initial tax is equal to five percent of the value of the excess business holdings held during the foundation's applicable taxable year. An additional tax is imposed if an initial tax is imposed and at the close of the applicable taxable period, the foundation continues to hold excess business holdings. The amount of the additional tax is equal to 200 percent of such holdings.

### **Explanation of Provision**

#### **Provisions relating to all supporting organizations (Type I, Type II, and Type III)**

##### Automatic excess benefit transactions

Under the provision, if a supporting organization (Type I, Type II, or Type III) makes a grant, loan, payment of compensation, or other similar payment to a substantial contributor (or person related to the substantial contributor) of the supporting organization, for purposes of the excess benefit transaction rules (sec. 4958), the substantial contributor is treated as a disqualified person and the payment is treated automatically as an excess benefit transaction with the entire amount of the payment treated as the excess benefit.<sup>569</sup> Accordingly, the substantial contributor is subject to an initial tax of 25 percent of the amount of the payment under section 4958(a)(1) and an organization manager that participated in the making of the payment, knowing that the payment was a grant, loan, payment of compensation, or other similar payment to a substantial contributor, is subject to a tax of 10 percent of the amount of the payment under section 4958(a)(2). The second tier taxes and other rules of section 4958 also apply to such payments. Other similar payments include payments in the nature of a grant, loan, or payment of compensation, such as an expense reimbursement. Other similar payments do not include, for example, a payment made pursuant to a bona fide sale or lease of property with a substantial contributor. Such payments are subject to the general rules of section 4958 if the substantial contributor meets the definition of a disqualified person under section 4958(f), but are not subject to the automatic excess benefit transaction rule of the provision. The provision applies to

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<sup>566</sup> Sec. 4943(c)(6).

<sup>567</sup> Sec. 4943(c)(7).

<sup>568</sup> Sec. 4943(d)(3).

<sup>569</sup> The requirement of the provision that the entire amount of the payment be treated as the amount of the excess benefit differs from the generally applicable rule of section 4958, which provides that the excess benefit is the amount by which the value of the economic benefit provided exceeds the value of the consideration received.

payments by a supporting organization to a substantial contributor but not to payments by a substantial contributor to a supporting organization.

Under the provision, a substantial contributor means any person who contributed or bequeathed an aggregate amount of more than \$5,000 to the organization, if such amount is more than two percent of the total contributions and bequests received by the organization before the close of the taxable year of the organization in which the contribution or bequest is received by the organization from such person. In the case of a trust, a substantial contributor also includes the creator of the trust. A substantial contributor does not include a public charity (other than a supporting organization). Under the provision, mechanical rules similar to the rules that apply in determining whether a person is a substantial contributor to a private foundation (secs. 509(d)(2)(B) and (C)) apply.

Under the provision, a person is a related person (“related person”) if a person is a member of the family (determined under section 4958(f)(4)) of a substantial contributor, or a 35 percent controlled entity, defined as a corporation, partnership, trust, or estate in which a substantial contributor or family member thereof owns more than 35 percent of the total combined voting power, profits interest, or beneficial interest, as the case may be.

In addition, under the provision, loans by any supporting organization (Type I, Type II, or Type III) to a disqualified person (as defined in section 4958) of the supporting organization are treated as an excess benefit transaction under section 4958 and the entire amount of the loan is treated as an excess benefit. For this purpose, a disqualified person does not include a public charity (other than a supporting organization).

#### Disclosure requirements

Under the provision, all supporting organizations are required to file an annual information return (Form 990 series) with the Secretary, regardless of the organization’s gross receipts. A supporting organization must indicate on such annual information return whether it is a Type I, Type II, or Type III supporting organization and must identify its supported organizations.

Under the provision, supporting organizations must demonstrate annually that the organization is not controlled directly or indirectly by one or more disqualified persons (other than foundation managers and other than one or more publicly supported organizations) through a certification on the annual information return. It is intended that supporting organizations be able to certify that the majority of the organization’s governing body is comprised of individuals who were selected based on their special knowledge or expertise in the particular field or discipline in which the supporting organization is operating, or because they represent the particular community that is served by the supported public charities.

#### Disqualified person

Under the provision, for purposes of the excess benefit transaction rules (sec. 4958), a disqualified person of a supporting organization is treated as a disqualified person of the supported organization.

## **Provisions that apply to Type III supporting organizations**

### Payout with respect to Type III supporting organizations

Under the provision, the Secretary shall promulgate new regulations on payments required by Type III supporting organizations that are not functionally integrated Type III supporting organizations.<sup>570</sup> Such regulations shall require such organizations to make distributions of a percentage either of income or assets to the public charities they support in order to ensure that a significant amount is paid to such supported organizations. A functionally integrated Type III supporting organization is a Type III supporting organization that is not required under regulations established by the Secretary to make payments to supported organizations due to the activities of the organization related to performing the functions of, or carrying out the purposes of, such supported organizations.<sup>571</sup>

### Excess business holdings

Under the provision, the excess business holdings rules of section 4943 are applied to Type III supporting organizations (other than functionally integrated Type III supporting organizations). In applying such rules, the term disqualified person has the meaning provided in section 4958, and also includes substantial contributors and related persons and any organization that is effectively controlled by the same person or persons who control the supporting organization or any organization substantially all of the contributions to which were made by the same person or persons who made substantially all of the contributions to the supporting organization. The excess business holdings rules do not apply if, as of November 18, 2005, the holdings were held (and at all times thereafter, are held) for the benefit of the community pursuant to the direction (made as of such date) of a State attorney general or a State official with jurisdiction over the Type III supporting organization.

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<sup>570</sup> See Treas. Reg. sec. 1.509(a)-4(i)(3)(iii).

<sup>571</sup> The current such regulation is Treasury regulation section 1.509(a)-4(i)(3)(ii). Under Treasury regulation section 1.509(a)-4(i)(3), the integral part test of current law may be satisfied in one of two ways, one of which requires a payout of substantially all of an organization's income to or for the use of one or more publicly supported organizations, and one of which does not require such a payout. There is concern that the current income-based payout does not result in a significant amount being paid to charity if assets held by a supporting organization produce little to no income, especially in relation to the value of the assets held by the organization, and as compared to amounts paid out by nonoperating private foundations. There also is concern that the current regulatory standards for satisfying the integral part test not by reason of a payout are not sufficiently stringent to ensure that there is a sufficient nexus between the supporting and supported organizations. In revising the regulations, the Secretary has the discretion to determine whether it is appropriate to impose a pay out requirement on any or all organizations not currently required to pay out. It is intended that, in revisiting the current regulations, if the distinction between Type III supporting organizations that are required to pay out and those that are not required to pay out is retained, which may be appropriate, the Secretary nonetheless shall strengthen the standard for qualification as an organization that is not required to pay out. For example, as one requirement, the Secretary may consider whether substantially all of the activities of such an organization should be activities in direct furtherance of the functions or purposes of supported organizations.

The Secretary has the authority not to impose the excess business holdings rules if the organization establishes to the satisfaction of the Secretary that excess holdings of an organization are consistent with the purpose or function constituting the basis of the organization's exempt status. In exercising this authority, the Secretary should consider, in addition to any other factors the Secretary considers significant, as favorable, but not determinative, factors, a reasoned determination by the State attorney general with jurisdiction over the supporting organization, that disposition of the holdings would have a severe detrimental impact on the community, and a binding commitment by the supporting organization to pay out at least five percent of the value of the organization's assets each year to its supported organizations. A reasoned determination would require, among other things, evidence that any such determination was made pursuant to serious study by the State attorney general of the issues involved in disposing of the excess holdings, and findings by the State attorney general about the detrimental economic impact that would result from such disposition. If as a result of such State attorney general's study and findings, the State attorney general directed as a matter of State law that permission of the State would be required prior to any sale of the holdings, such a factor should be given strong consideration by the Secretary.

Transition rules apply to the present holdings of an organization similar to those of section 4943(c)(4)-(6).<sup>572</sup>

Under the provision, the excess business holdings rules also apply to Type II supporting organizations but only if such organization accepts any gift or contribution from a person (other than a public charity, not including a supporting organization) who (1) controls, directly or indirectly, either alone or together (with persons described below) the governing body of a supported organization of the supporting organization,<sup>573</sup> (2) is a member of the family of such a person; or (3) is a 35 percent controlled entity.

#### Organizational and operational requirements

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<sup>572</sup> Under the transition rules, in general, where the existing holdings of a supporting organization and disqualified persons are in excess of 50 percent (of a voting stock interest, profits interest, or beneficial interest), and not 20 percent or 35 percent as under the general rule, but are not in excess of 75 percent, a 10-year period is available before the holdings must be reduced to 50 percent. If such holdings are more than 75 percent, the reduction to 50 percent need not occur for a 15-year period. The 15-year period is expanded to 20 years if the holdings are more than 95 percent. After the expiration of the 10, 15, or 20 year period, if disqualified persons have holdings in a business enterprise in excess of two percent of the enterprise, the supporting organization has 15 additional years to dispose of any of its own holdings that are above 25 percent of the holdings in the enterprise. If disqualified persons do not have such holdings, then the supporting organization has 15 additional years to dispose of any of its own holdings that are above 35 percent of the holdings in the enterprise.

<sup>573</sup> For purposes of the provision, it is intended that indirect control includes the ability to exercise effective control. For example, if a person made a gift to a supporting organization and a combination of such person, a person related to such person, and such person's personal attorney were members of the five-member board of a supported organization of the supporting organization, the organization would be treated as being indirectly controlled by such person. Board membership alone does not establish direct or indirect control.

The provision provides that, in general, after the date of enactment, a Type III supporting organization may not support an organization that is not organized in the United States.<sup>574</sup> But, for Type III supporting organizations that support a foreign organization on the date of enactment, the provision provides that the general rule does not apply until the first day of the third taxable year of the organization beginning after the date of enactment.

#### Relationship to supported organization(s)

Under the provision, a Type III supporting organization must apprise each organization it supports of information regarding the supporting organization in order to help ensure the supporting organization's responsiveness. It is intended that such a showing could be satisfied, for example, through provision of documentation such as a copy of the supporting organization's governing documents, any changes made to the governing documents, the organization's annual information return filed with the Secretary (Form 990 series), any tax return (Form 990-T) filed with the Secretary, and an annual report (including a description of all of the support provided by the supporting organization, how such support was calculated, and a projection of the next year's support). It is intended that failure to make a sufficient showing is a factor in determining whether the responsiveness test of present law is met.

In general, under the provision, a Type III supporting organization that is organized as a trust must, in addition to present law requirements, establish to the satisfaction of the Secretary, that it has a close and continuous relationship with the supported organization such that the trust is responsive to the needs or demands of the supported organization. A transition rule for existing trusts provides that the provision is not effective until one year after the date of enactment but is effective on the date of enactment for other trusts.

#### Other provisions

Under the provision, if a Type I or Type III supporting organization accepts any gift or contribution from a person (other than a public charity, not including a supporting organization) who (1) controls, directly or indirectly, either alone or together (with persons described below) the governing body of a supported organization of the supporting organization; (2) is a member of the family of such a person; or (3) is a 35 percent controlled entity, then the supporting organization is treated as a private foundation for all purposes until such time as the organization can demonstrate to the satisfaction of the Secretary that it qualifies as a public charity other than as a supporting organization.

Under the provision, a nonoperating private foundation may not count as a qualifying distribution under section 4942 any amount paid to (1) a Type III supporting organization that is not a functionally integrated Type III supporting organization or (2) any other supporting

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<sup>574</sup> U.S. charities established principally to provide financial and other assistance to a foreign charity, sometimes referred to as "friends of" organizations, may not be established as supporting organizations under the provision. Such organizations may continue to obtain public charity status, however, by virtue of demonstrating broad public support (as described in sections 509(a)(1) and 509(a)(2)).

organization if a disqualified person with respect to the foundation directly or indirectly controls the supporting organization or a supported organization of such supporting organization. Any amount that does not count as a qualifying distribution under this rule is treated as a taxable expenditure under section 4945.

### **Effective Date**

The provision generally is effective on the date of enactment. The excess benefit transaction rules are effective for transactions occurring after July 25, 2006 (except that the rule relating to the definition of a disqualified person is effective for transactions occurring after the date of enactment). The excess business holdings requirements are effective for taxable years beginning after the date of enactment. The provision relating to distributions by nonoperating private foundations is effective for distributions and expenditures made after the date of enactment. The return requirements are effective for returns filed for taxable years ending after the date of enactment.