

**More Than Pensions:  
What Estate Planners Need to Know About  
The Pension Protection Act of 2006**

*New Charitable Giving Incentives  
New Charitable Reforms*

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# CHARITABLE IRA ROLLOVER IN 2006 AND 2007

## I. Introduction

The Pension Protection Act of 2006 provides that in 2006 and 2007, a person over age 70 ½ can make charitable gifts directly from an Individual Retirement Account ("IRA") of up to \$100,000 per year. The donor will benefit by not having to report the IRA distribution as taxable income, although the donor will not be able to claim a charitable income tax deduction for the gift.

Eligible IRA owners can use charitable gifts from their IRAs to satisfy their annual minimum distribution requirement. For example, a 76 year old who would normally be required to receive a taxable distribution of just over 4% from an IRA could instead contribute 3% to a charity and receive a taxable distribution of just 1%.<sup>1</sup>

The new law makes no change to the rules that govern charitable bequests of IRA assets, either outright to charities or to deferred giving arrangements. Such transactions qualified for favorable income tax consequences in the past and will continue to be an attractive planning strategy in the future. The new law only changes the rules for lifetime charitable gifts from IRAs.

The new law permits distributions to be made from IRAs directly to charities. The new law does not compel IRA administrators to make such distributions when they receive instructions from the IRA account owner. Thus, for example, whereas in theory every eligible person who claims the standard deduction will want to make each and every charitable gifts directly from her or his IRA, the IRA administrators don't want to spend time cutting thousands or millions of checks for just \$10 or \$20. They need to be able to administer these grants in a cost-efficient manner and develop a rational and reasonable fee structure. The charitable sector needs to be supportive of the needs and concerns of IRA administrators in order for the full potential of charitable IRA rollover to actually be realized.

## II Who Wins With Charitable IRA Rollover?

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<sup>1</sup> "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." *Technical Explanation of H.R. 4, The "Pension Protection Act of 2006,"* Joint Committee on Taxation, JCX-38-06 (August 3, 2006) at page 266.

## A. Donors who don't itemize their deductions

Probably the biggest winners of this new law are IRA owners over age 70 ½ who do not itemize income tax deductions (i.e., they take the standard deduction). Since the charitable deduction is an itemized deduction, they had the worst tax consequences from the gifts they made from their IRAs: they had to report the entire distribution as taxable income but received no offsetting income tax deduction.

Nearly two thirds of American taxpayers claim the standard deduction and the percentage is even higher for taxpayers over age 70 ½. By comparison, the new charitable IRA rollover law gives eligible IRA donors the equivalent of an unlimited charitable income tax deduction for up to \$100,000 of the charitable gifts that they make from their IRAs.

Although non-itemizers are typically middle and lower income taxpayers, many are wealthy. The IRS estimates that there are 5.2 million *higher-income taxpayers* who claim the standard deduction and cannot get any tax benefit from their charitable gifts.<sup>2</sup> They tend to live in the nine states that do not have a state income tax: **Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington and Wyoming**. Donors (and, consequently, charities) who reside in these states will generally benefit more from the new charitable IRA rollover law than donors who live in other states.

### TAXPAYERS WHO USE THE STANDARD DEDUCTION AND RECEIVE NO FEDERAL TAX BENEFIT FROM CHARITABLE GIFTS 2001 Federal Income Tax Returns

	All Taxpayers	AGI Over \$100,000	AGI Over \$200,000
<b>Nationwide</b>	<b>65%</b>	<b>9%</b>	<b>7%</b>
<b>Detail on Selected States</b>			
<b>-- States With A State Income Tax</b>			
California	61%	4%	2%
New York	61%	1%	1%
Ohio	65%	5%	2%
<b>-- States With No State Income Tax</b>			
Florida	71%	20%	19%
Texas	77%	21%	21%

## B. Donors Who Lose Tax Deductions As AGI (adjusted gross income) Increases.

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<sup>2</sup> Parisi, Michael and Hollenbeck, Scott, "Individual Income Tax Returns, 2003," *Statistics of Income Bulletin*, Internal Revenue Service, Fall, 2005, at. p. 13.

**1. The 2% (formerly 3%) phaseout of itemized deductions.** The most common lost deduction is the phaseout of itemized deductions as income increases over \$150,500 (\$75,250 if married filing separately). The phaseout was 3% in 2005 but is only 2% in 2006 and 2007. By keeping AGI low, donors can deduct more of their itemized deductions.

**2. Phaseout of \$3,300 Dependent & Personal Exemption Deductions.** Wealthy taxpayers cannot claim personal exemptions for themselves or their dependents. By avoiding the recognition of IRA distributions, taxpayers in the affected thresholds may be able to deduct personal exemptions and dependent deductions. The thresholds for phaseout in 2006 begin at the following AGI levels and are phased out at the rate of 2 percent for every AGI increase of \$2,500:

Married Filing Jointly (\$225,750), Head of Household (\$188,150), Single (\$150,500) and Married Filing Separately (\$112,875).

**3. Reduced Income Tax on Social Security Payments.** If a social security recipient's modified AGI is over either \$44,000 or \$34,000, 85% of the social security payments are taxable and 15% are tax-exempt. However, if modified AGI is under either \$32,000 or \$25,000, then all of the social security payments are tax-exempt. By avoiding the recognition of taxable IRA distributions an eligible social security recipient may be able to pay less tax on social security distributions. To be more specific, the thresholds are \$44,000 and \$32,000 if married filing jointly and they are \$34,000 and \$25,000 if filing single or head-of-household. The thresholds might not apply to married individuals who live together and file separately.

**4. Other Deductions That Are Phased out as AGI Increases.** Other deductions that are subject to income phase-outs, and the rates of phase-out, are:

- \* 2% for "miscellaneous itemized deductions" (employee expense and investment expense deductions)
- \* 7 ½% for medical expense deductions
- \* 10% for nonbusiness casualty losses (e.g., damage to a vacation home)

**C. Donors who live in states with a state income tax that provides no tax breaks for charitable gifts: Indiana, Michigan, New Jersey, Ohio, Massachusetts and West Virginia** state income tax computations do not permit itemized deductions. Consequently, Indiana, Michigan, New Jersey, Ohio, Massachusetts and West Virginia residents gets no state income tax breaks from charitable gifts. Eligible donors in these states will save taxes at their highest marginal state income tax rate (e.g., 4% or 6%) for every charitable gift that they make from their IRAs instead of from their checking accounts. Although **Illinois** residents also cannot claim charitable income tax deductions, all distributions from retirement plans are exempt from the income tax so they would not see any benefit on their state returns from this new law. **Michigan and New Jersey** residents also might not see benefits since they may receive threshold amounts of retirement income exempt from state income tax and only excess amounts are subject to state taxes. The thresholds are \$10,000 (\$20,000 married) in New Jersey and about \$40,000 (\$80,000 married) in Michigan.

**D. Donors who are subject to the 50% annual charitable deduction limitation.** Charitable deductions cannot exceed 50% of a taxpayer's adjusted gross income ("AGI") in any year.<sup>3</sup> A donor who is subject to the annual deduction limitation and who uses a taxable distribution from a retirement plan account to make an additional charitable gift would generally be able to deduct only 50% of the amount in the year of the gift. The other 50% of the distribution would be subject to income tax that year. If, instead, the charitable gift is made directly from an IRA, a donor over age 70 ½ would not pay any extra income tax.

**E. Wealthy Individuals Who Want to Reduce the Size of Retirement Assets in Their Estates.** Whereas most inherited stock, real estate and other assets receive a step-up in tax basis, inherited retirement distributions are generally taxed as income in respect of a decedent. The combination of estate taxes and income taxes – particularly in states that have both a state estate tax and a state income tax – can produce an effective tax rate on such inherited distributions of over 80%. Some senior citizens draw down their retirement accounts to reduce the proportion of their wealth in these assets. Charitable IRA rollover offers an opportunity to withdraw up to \$100,000 in a year for charitable gifts without triggering some of the problems that large distributions might normally cause (e.g., the phaseout of itemized deductions and the 50% charitable deduction limitation).

### III. Who Doesn't Win With Charitable IRA Rollover?

**A. Donors Who Are About To Sell Appreciated Stock and Appreciated Real Estate.** The sale of such property will trigger a 15% federal long-term capital gains tax. This tax could be avoided by instead donating the property to a charity before the sales negotiations are finalized. The issue, then, is whether the tax savings from charitable IRA rollover can exceed the pending 15% tax.

Charitable gifts of appreciated stock, mutual funds and real estate have traditionally provided donors with greater income tax benefits than gifts of most other types of assets. *In most cases, gifts of these assets will continue to provide greater tax benefits than gifts from an IRA.* On the other hand, if the donor is subject to some of the tax challenges described above – such as the 50% annual charitable income tax deduction limitation -- the donor could be better off making a gift from an IRA.

Example: Ms. Donor has a \$10,000 IRA and has stock worth \$10,000 that she bought years ago for \$2,000. She is 75 years old and has AGI of \$200,000. If she makes a charitable gift from her IRA under "charitable IRA rollover," she will save a little bit of money compared to receiving a taxable IRA distribution (\$140, or 1.4% of the distribution, due to the phaseout of her personal exemption and the 2% loss of itemized deductions). However, she will still own her stock. If she sells the stock, she will have an \$8,000 taxable gain subject to a

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<sup>3</sup> Secs. 170(b)(1)(A) and (C) and Reg. Sec. 1.170A-9(e)(11)(ii). There is a 5 year carryforward for the charitable contributions that exceed 50% of AGI. Sec. 170(b)(1)(C)(ii) and last sentence of Section 170(b)(1)(B).

federal 15% capital gains tax (\$1,200). Consequently, even with the opportunity to make a tax-free charitable gift from her IRA, she should probably receive taxable distributions from her IRA and contribute her stock to produce an offsetting charitable income tax deduction. She can use the cash from the distribution for any purpose that she chooses, including the purchase of new stock that will give her a new tax basis of \$10,000.

**Compare – wealthy donors in poor health have an incentive to keep appreciated stock and to instead make charitable gifts from their IRAs: “stepped-up basis.”** Whereas appreciated stock will receive a step-up in basis in the hands of the beneficiaries – generally the value at the time of death – retirement accounts receive no step-up in basis and distributions to beneficiaries are generally taxed as ordinary income. Many individuals – especially those who are so wealthy that their estates will be subject to estate tax – consciously strive to reduce the amount of retirement assets in their estates. If they plan to hold appreciated stock until death, they may prefer to make their charitable gifts from their IRAs rather than use appreciated stock.

Example: Ms. Donor has a \$10,000 IRA and has stock worth \$10,000 that she bought years ago for \$2,000. She loves the stock and does not think it wise to sell it. She is 75 years old, in poor health and has AGI of \$200,000 and would like to make a charitable gift of \$10,000.

She should use the IRA for her charitable gift. Upon her death the stock will receive a new tax basis – i.e., about \$10,000 – and the potential capital gains tax on the \$8,000 of appreciation would be eliminated. By comparison, had she donated the stock to charity and died with \$10,000 in an IRA, the distribution to her beneficiaries would produce \$10,000 of taxable income.

## **B. Donors Who Reside In States Where the State Income Tax Laws Pose Problems**

For example, the **Kentucky** state income tax laws exempt the first \$41,000 of retirement income but allows a charitable income tax deduction to reduce state income taxes. Consequently, a retiree who withdraws \$1,000 from an IRA and then donates \$1,000 to a charity usually has a tax advantage that the withdrawal was tax-free but the gift produced tax savings. Suppose that the \$1,000 charitable gift was made directly from the IRA. On the state income tax return the donor would not report any taxable income but would lose the state income tax deduction and, consequently, would pay more state income tax.

**C. Donors Who Would Not Receive Any Tax Savings from the Charitable IRA Exclusion and Who Encounter Administrative Hassles Trying to Make a Charitable Gift Directly from an IRA.** Millions of donors won't save any income taxes with the charitable IRA exclusion. Who are they? They are donors who itemize tax deductions (and can therefore deduct charitable gifts) with incomes under \$150,000 (so they are not subject to the 2% phase-out of itemized deductions), who can't realistically make social security benefits tax-exempt and who live in states that allow charitable income tax deductions. Most of these donors have not incurred a tax cost from their charitable gifts since the charitable income tax deduction has offset the taxable income from an IRA distribution. If the IRA administrator balks at making charitable grants from an IRA or has fees for the transaction, it will be much easier to simply receive a taxable distribution from an IRA and then write a check to make a charitable gift.

### III. LEGAL REQUIREMENTS

#### A. Overview

A person over age 70 ½ who makes an outright charitable gift from her or his IRA:

- (1) will not report the distribution as taxable income,<sup>4</sup> and
- (2) will not be entitled to claim a charitable income tax deduction for the gift.<sup>5</sup>

#### B. Technical Requirements

In order to make a lifetime charitable gift from an IRA without having to report the payment as a taxable distribution, the distribution must meet the definition of a "**qualified charitable distribution**" (hereafter "**QCD**").<sup>6</sup> Unless a distribution qualifies as a QCD, any lifetime charitable gift from any sort of retirement plan account (IRA, 403(b), 401(k), profit sharing, etc.) must be reported as a taxable distribution. The donor can then claim an offsetting charitable income tax deduction.

There are seven requirements for an IRA distribution to qualify as a QCD:

**1. Donor must be at least age 70 ½.** The distribution must be made on or after the date that the IRA owner attained age 70 ½.<sup>7</sup> In most cases such donors will be retirees. Donors under age 70 ½ will have to report charitable gifts from their IRAs as taxable distributions and can claim offsetting charitable income tax deductions if they itemize their deductions.

*Tax Trap in The Year a Person Attains Age 70 ½:* There can be a lot of confusion in the year that a person attains age 70 ½. All distributions that are made at any time during that year can be applied toward satisfying the minimum distribution requirement to avoid the 50% penalty tax for insufficient distributions. However, only the distributions that are made after attaining the age of 70 ½ qualify

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<sup>4</sup> Sec. 408(d)(8)(A).

<sup>5</sup> Sec. 408(d)(8)(E).

<sup>6</sup> Sec. 408(d)(8)(B).

<sup>7</sup> Sec. 408(d)(8)(B)(ii).

for the charitable exclusion. This can be a problem for someone who attains age 70 ½ late in the year, say on December 28. The law should be changed by a technical corrections act to conform the charitable IRA rollover rules with the minimum distribution requirements. That is, all distributions should qualify for the charitable exclusion if made "within or after the calendar year that the individual for whose benefit the plan is maintained has attained age 70 ½". Tax administration would be simplified and innocent parties would not be caught in a tax trap.

**2. IRAs only.** The distribution must be made from an individual retirement plan.<sup>8</sup> That means only an IRA – not a qualified retirement plan or a Section 403(b) annuity. Distributions to charities from other types of retirement accounts – such as 403(b) plans, 401(k) plans, profit sharing plans and pension plans – will still have to be reported as taxable distributions to the account owners. Another trap that may lead to confusion is that charitable gifts from SEPs and SIMPLE plans, which are basically IRAs that receive employer contributions, are ineligible for the exclusion.

In most cases, the restriction of such favorable tax treatment to IRAs should not pose a significant problem. Many retirees have large IRA balances because they rolled over distributions from their company retirement accounts into IRAs when they retired. Donors without IRAs who would like to take advantage of charitable IRA rollover can establish a new IRA and then rollover some assets from their other qualified retirement plans into the new IRA.<sup>9</sup>

**3. Directly from the IRA to the charity.**<sup>10</sup> The check from the IRA must be issued payable to the charity. If a check is issued from the IRA payable to the IRA owner who then endorses the check to the charity, it must be reported as a taxable distribution to the IRA owner.

Does the IRA Administrator have to mail the check to the charity? Can the check be issued payable to a charity and then mailed to the IRA account owner who then forwards the check to the charity? Much of this boils down to what the word “directly” means. Guidance will certainly be forthcoming to resolve this issue. See the analysis below in issue number 7.

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<sup>8</sup> Sec. 408(d)(8)(B).

<sup>9</sup> Sec. 408(d)(3). Employees who receive distributions from any type of qualified retirement account can rollover the distribution to an IRA.

<sup>10</sup> Sec. 408(d)(8)(B)(ii).

**4. The recipient organization must be a public charity or a conduit private foundation.** The recipient organization must be described in Sec. 170(b)(1)(A).<sup>11</sup> This statute includes most public charities as well as private *operating* foundations. **Two exceptions: donor advised funds and supporting organizations:** Although contributions to donor advised funds and Sec. 509(a)(3) supporting organizations qualify for public charity tax deductions, they are not eligible beneficiaries for charitable IRA rollover. In that case, the donor must report the IRA distribution as taxable income and then claim an offsetting charitable income tax deduction.

Grant-making private foundations are generally excluded, except the legislation appears to permit grants from IRAs to two types of grant-making private foundations: conduit private foundations and donor-directed funds.<sup>12</sup> A conduit private foundation is typically a grant-making foundation that in any given year makes an election to distribute by March 15 (oversimplified) 100% of the contributions that it received that year. A donor-directed fund allows a donor to control, not just advise, the recipient of the fund's income. Private operating foundations, such as libraries and museums that are endowed by one family, are also eligible recipients.<sup>13</sup> However, payments to organizations that qualify for charitable income tax deductions but which are not eligible public charities – notably veterans organizations, certain fraternal organizations and cemetery companies – are not eligible for the charitable exclusion for IRA distributions.<sup>14</sup>

OBSERVATION: It is unfortunate that donor advised funds and grant-making private foundations were excluded as eligible recipients. There have been a few publicized scandals in recent years, but the overwhelming majority are well administered. They specialize in making charitable grants and could prove helpful to implement charitable IRA rollover in a manner that furthers Congressional policies and objectives. For example, at well-managed community foundations, Jewish federations and commercial-affiliated gift funds, it is standard practice that when a check is issued from a donor advised fund to a charity, the transmittal letter (and sometimes even the back of the check) contains instructions that the charity should not cash the check, and should notify the sponsoring organization, if the donor would obtain a personal financial benefit from the payment. Policies such as this one would be helpful to implement charitable IRA rollover.

**5. The payment would otherwise fully qualify for a full charitable income tax deduction.**<sup>15</sup>

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<sup>11</sup> Sec. 408(d)(8)(B)(i).

<sup>12</sup> Conduit private foundations are described in Sec. 170(b)(1)(A) and so therefore be eligible. Specifically, they are described in Sec. 170(b)(1)(A)(vii) and Sec. 170(b)(1)(E)(ii). Donor directed funds are described in Sec. 170(b)(1)(A)(vii) and Sec. 170(b)(1)(E)(iii).

<sup>13</sup> Private operating foundations are described in Sec. 170(b)(1)(A)(vii) via Sec. 170(b)(1)(E)(i).

<sup>14</sup> Charities are one of five categories of organization that are eligible to receive contributions that qualify for charitable income tax deductions: (1) governments, (2) U.S. charities, (3) veterans organizations, (4) certain fraternal organizations and (5) cemetery companies. Sec. 170(c). Charitable IRA rollover must instead be organizations described in Sec. 170(b)(1)(A) – generally public charities.

<sup>15</sup> Sec. 408(d)(8)(C).

A distribution will qualify as a QCD only if a person would normally be able to claim a charitable income tax deduction for the entire payment. This eliminates favorable tax treatment for IRA distributions that are used for auctions, raffle tickets, fund-raising dinners or any other type of *quid-pro-quo* transaction. If there is any financial benefit, then the entire distribution is taxable income and the donor must hope to get a partially offsetting charitable income tax deduction. This eliminates the possibility that an IRA distribution will qualify as a QCD if it is used to obtain a *charitable gift annuity*.

**6. Distribution would otherwise be a taxable distribution, with a maximum amount of \$100,000 per year.**<sup>16</sup> By way of background, most IRA distributions are fully taxable. However, if an IRA owner made any nondeductible contributions to the IRA, then those distributions to the IRA owner are normally tax-free. A QCD only applies to the taxable portion, and only to the extent of the first \$100,000 of such distributions in 2006 and 2007.

If an IRA contains any non-deductible contributions, the new law provides very favorable tax treatment. Charitable distributions are deemed to come first from the taxable portion, thereby leaving the maximum amount of tax-free dollars in the IRA.<sup>17</sup> An example is in the footnote.<sup>18</sup>

If any tax-free amounts are distributed to a charity, that portion does not qualify as a QCD. Instead, the donor is deemed to have received that amount free from income tax and can claim a charitable income tax deduction for a charitable gift of that part of the payment.

**7. Donor must have documentation from the charity that would qualify the gift for a full charitable income tax deduction under normal circumstances.**

Part of the challenge of this new law is that the donor will have to obtain documentation from the charity similar to what is normally required in order to deduct cash gifts.<sup>19</sup> For gifts of \$250 or more

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<sup>16</sup> Sec. 408(d)(8)(B) (last sentence).

<sup>17</sup> Sec. 408(d)(8)(D).

<sup>18</sup> Example: An IRA owner has a traditional IRA with a balance of \$100,000, consisting of \$20,000 of nondeductible contributions and \$80,000 of deductible contributions and accumulated earnings. Normally, 80% of a distribution to the IRA owner would be taxable and 20% would be a tax-free return of non-deductible contributions. If however, there is a distribution to a charity that qualifies as a QCD, all of the distribution is deemed to come first from the taxable portion. Thus, if the IRA trustee makes an \$80,000 distribution to a charity, the entire \$80,000 is deemed to come from the taxable portion of the IRA and is a QCD. No amount is included in the IRA owner's taxable income. The \$20,000 that remains in the IRA is treated as entirely nondeductible contributions.

Modified from from Example 2 of *Technical Explanation Of H.R. 4, The Pension Protection Act of 2006*, prepared by the Staff of the Joint Committee On Taxation August 3, 2006 (JCX-38-06) on page 268.

<sup>19</sup> 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

the charity must issue a “contemporary written acknowledgment” that describes the amount of cash contributed and that certifies that the donor did not receive any financial benefits in exchange for the gift.<sup>20</sup> For gifts under \$250, the donor must have a bank record or a receipt from the charity that contains the name of the charity, the date of the contribution and the amount of the gift.<sup>21</sup> Failure to obtain such an acknowledgment will cause the IRA distribution to be a taxable distribution to the IRA account owner and, in the absence of the documentation necessary to justify a charitable income tax deduction, presumably might cause the person to lose an offsetting charitable income tax deduction.

Obviously there can be a lot of confusion if thousands of checks are sent to charities from IRAs without correctly identifying the IRA owner and that person’s address. Much of this boils down to what the word “directly” means: “which is made directly by the [IRA] trustee to an organization described in section 170(b)(1)(A).”

OBSERVATION: IRA administrators are waiting for the Service to issue guidance on how such transactions will be reported on Form 1099-R. At one extreme IRA administrators may be asked to make grants as if the IRAs were donor advised funds: they would have to investigate the organization; verify there was no personal benefit; etc. If this is the case, the administrative requirements could stifle charitable grants from IRAs. At the other extreme, the IRA administrator could simply issue checks to every organization named by the IRA owner, without investigating whether the recipient was an eligible charity, and then mail the checks to the IRA owner. In that case, the IRA administrator might have issued checks payable to a charity, to a Sec. 501(c)(4) social welfare organization, to a Sec. 501(c)(6) chamber of commerce ... to any organization. Then at the end of the year the IRA administrator simply reports the total amount of distributions as *taxable* distributions. This usually occurs on the Form 1099-R that is sent to the IRA owner and to the IRS. Hopefully the IRS will design a tax form where the donor can list the recipient organizations

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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.” (Emphasis added). *Technical Explanation of H.r. 4, The "Pension Protection Act of 2006,"* Joint Committee on Taxation, JCX-38-06 (August 3, 2006) at page 267.“

<sup>20</sup> Sec. 170(f)(8). For a contribution from an IRA, there cannot be any such benefit.

<sup>21</sup> Sec. 170(f)(17), added by Sec. 1217 of the Pension Protection Act of 2006, effective beginning in 2007

together with a certification by the IRA account owner that every listed organization was an eligible recipient, there was no personal benefit, and that the IRA account owner has receipts from the charity that verify these claims. Charitable IRA rollover will work best if there is a minimal burden on IRA administrators. The burden of accurately complying with the Charitable IRA rollover laws - the identification of eligible charities and the absence of personal financial benefit -- should be borne exclusively by the IRA account owner and the IRA administrator should be free from all liability.

#### IV. CONCLUSION

There will be administrative obstacles in the short term as IRA administrator learn to adapt to this new law. IRA administrators will be reluctant to invest a lot of effort to modify computer systems for a law that will expire at the end of 2007. An eligible IRA owner over the age of 70- 1/2 should, therefor, only attempt to make a charitable IRA rollover if the tax savings exceed the administrative costs that the transaction might generate. For people who itemize their deductions and can claim offsetting charitable income tax deduction, it will usually be administratively easier to simply receive a check from the IRA and then make a charitable gift. However, for those individuals who do not itemize, who live in states with no charitable deduction or who otherwise benefit by keeping their AGI lower, it may be worth the effort to work with the IRA administrator to make that large charitable gift from the IRA.

#### FULL TEXT OF CHARITABLE IRA ROLLOVER STATUTE:

##### Sec. 408(d)(8) DISTRIBUTIONS FOR CHARITABLE PURPOSES-

`(A) IN GENERAL- So much of the aggregate amount of qualified charitable distributions with respect to a taxpayer made during any taxable year which does not exceed \$100,000 shall not be includible in gross income of such taxpayer for such taxable year.

`(B) QUALIFIED CHARITABLE DISTRIBUTION- For purposes of this paragraph, the term 'qualified charitable distribution' means any distribution from an individual retirement plan (other than a plan described in subsection (k) or (p))--

`(i) which is made directly by the trustee to an organization described in section 170(b)(1)(A) (other than any organization described in section 509(a)(3) or any fund or account described in section 4966(d)(2)), and

`(ii) which is made on or after the date that the individual for whose benefit the plan is maintained has attained age 70 1/2 .

A distribution shall be treated as a qualified charitable distribution only to the extent that the distribution would be includible in gross income without regard to subparagraph (A).

`(C) CONTRIBUTIONS MUST BE OTHERWISE DEDUCTIBLE- For purposes of this paragraph, a distribution to an organization described in subparagraph (B)(i) shall be treated as a qualified charitable distribution only if a deduction for the entire distribution would be allowable under section 170 (determined without regard to subsection (b) thereof and this paragraph).

(D) APPLICATION OF SECTION 72- Notwithstanding section 72, in determining the extent to which a distribution is a qualified charitable distribution, the entire amount of the distribution shall be treated as includible in gross income without regard to subparagraph (A) to the extent that such amount does not exceed the aggregate amount which would have been so includible if all amounts distributed from all individual retirement plans were treated as 1 contract under paragraph (2)(A) for purposes of determining the inclusion of such distribution under section 72. Proper adjustments shall be made in applying section 72 to other distributions in such taxable year and subsequent taxable years.

(E) DENIAL OF [CHARITABLE] DEDUCTION- Qualified charitable distributions which are not includible in gross income pursuant to subparagraph (A) shall not be taken into account in determining the deduction under section 170.

(F) TERMINATION- This paragraph shall not apply to distributions made in taxable years beginning after December 31, 2007. \* \* \* (c) Effective Dates-- The amendment made by subsection (a) shall apply to distributions made in taxable years beginning after December 31, 2005.

### **TAX INCENTIVE FOR CHARITABLE GIFTS BY SUBCHAPTER S CORPORATIONS OF APPRECIATED PROPERTY**

In 2006 and 2007, charitable gifts by S corporations will qualify for the same favorable income tax treatment that currently applies to such charitable gifts made by partnerships and limited liability companies ("LLCs"). Until this law was enacted, such gifts by S corporations were subject to a comparable tax disadvantage.

By way of background, normally the prime situation for obtaining a tax benefit from a charitable gift of appreciated property is to make the gift shortly before its sale, but this strategy does not work well with a gift of S corporation assets. Rather than incur the cost of an appraisal for a gift of appreciated property, it may be easier for the corporation to sell its assets and then make a cash gift. If, however, the property would be subject to a Sec. 1374 built-in gains tax, then there could be significant tax savings from making a charitable contribution of the property before the corporation sells all of its assets. The purchaser could acquire those assets from the charity.

**EXAMPLE:** Assume that an S corporation with only one shareholder is about to sell all of its assets. *The corporation has \$1 million of assets with a cost basis of \$400,000, which if sold would produce a \$600,000 gain.* Assume that the shareholder's stock has the same numbers: \$1 million value and \$400,000 basis. If the corporation sold all of its assets and the gain was taxed to the shareholder, the basis in the stock would increase to \$1 million (\$400,000 + \$600,000 taxable gain). Thus, when the corporation distributes the \$1 million cash proceeds to the shareholder in liquidation, the shareholder would not recognize a gain upon liquidation. The shareholder could then make a charitable cash gift of \$100,000 and claim a \$100,000 charitable income tax deduction. The end result would be \$600,000 of taxable gain and a \$100,000 charitable tax deduction. Rather than sell all of its assets, the corporation might make a charitable contribution of some of its appreciated property before the anticipated sale. Among the corporation's assets is appreciated real estate with a value of \$100,000 and a cost basis of \$20,000. To claim a charitable tax deduction for a gift of the real estate, the corporation would have to pay for a qualified appraisal. If the corporation donates the real estate to a charity before the sale, the shareholder could deduct a \$100,000 charitable gift but has to reduce her basis in her stock by the full \$100,000 -- from

\$400,000 to \$300,000. When the corporation sells the remainder of its assets for \$900,000, the corporation will recognize a gain of \$520,000 (\$900,000 sale price minus the remaining \$380,000 basis that the corporation has in its assets).

**CHARITABLE GIFT UNDER PRIOR LAW:** The problem was that when the corporation liquidates and distributes the \$900,000 cash to the shareholder, the shareholder will have to recognize a taxable gain of \$80,000. This is because the shareholder's stock basis is only \$820,000 (original \$400,000 minus \$100,000 charitable deduction plus \$520,000 taxable gain). *Thus, despite the charitable gift, the shareholder will ultimately recognize the same \$600,000 taxable gain* (\$520,000 when corporation sells assets plus \$80,000 on liquidation) that the shareholder would have recognized had there been no charitable gift of property at all. It would be simpler to sell the assets and give cash. By comparison, if a partnership or a LLC made the same gift, the owner's basis in the partnership interest or LLC interest would be reduced only by the \$20,000 cost basis rather than the appreciated \$100,000 market value and there would indeed be a tax advantage to a gift of appreciated property before its sale.

**NEW LAW FOR 2006 and 2007:** The S corporation would have parallel treatment: the shareholder's basis in the stock is only by the \$20,000 cost basis rather than the appreciated \$100,000 market value and there would indeed be a tax advantage to a gift of appreciated property before its sale. *The shareholder would only recognize a \$520,000 gain when the remaining assets are sold.*

**SPECIAL APPEAL: CHARITABLE GIFT BY S CORPORATION WITH BUILT-IN GAINS TAX ("SEC. 1374") PROPERTY.** When a Subchapter C corporation converts to a Subchapter S corporation, a special tax is triggered if the corporation disposes of any appreciated property that it owned on the date of conversion -- whether by sale or distribution to the shareholders -- within ten years of the conversion date. Such a disposition will usually trigger both a taxable gain to the shareholders under the Subchapter S rules and a Sec. 1374 income tax liability to the corporation based on the value of the property on the conversion date. The built-in gains tax is by far the most frequent and largest of the three corporate taxes that S corporations pay. Therefore, it was a significant development when the IRS concluded in a private letter ruling that no such tax would be triggered by an outright charitable gift of such property within ten years of the conversion date.<sup>22</sup> There is no comparable IRS pronouncement on the consequences of a deferred charitable gift of such property, such as a contribution to a charitable remainder trust.

**CAUTION: DANGER IF CHARITABLE GIFT IS TOO BIG:** If an S Corporation donates "substantially all" of its assets to a charity, the corporation will be treated as if it had liquidated. This will trigger an income tax liability as if the corporation had sold its assets to an unrelated buyer.

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<sup>22</sup> The Service ruled that an S corporation that donated appreciated real estate to a governmental entity could claim a charitable deduction equal to the full value of the property and would not have to recognize the built-in gains tax under section 1374 from such a disposition. The corporation had owned the real estate at the time it converted from Subchapter C status to Subchapter S status. Private Letter Ruling 200004032 (Jan 28, 2000).

## LIFE INSURANCE CONTRACTS

Excerpt from *Technical Explanation of H.r. 4, The "Pension Protection Act of 2006,"* Joint Committee on Taxation, JCX-38-06 (August 3, 2006) at pages 284-286:

### **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, and private investors have an interest in the contract. 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....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 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....

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....  
**provision is effective on the date of enactment.**

# DONOR ADVISED FUNDS & SUPPORTING ORGANIZATIONS

## THE LEGAL LANDSCAPE

- 1930 The first donor advised fund is established. There are conflicting reports as to whether it was The Barstow Fund at The New York Community Trust or a different fund at the Winston-Salem Foundation. The New York Community Trust worked with many trusts that were established by living donors whereas, by comparison, the charitable trusts at The Cleveland Foundation and many other community foundations were generally established as bequests. Living donors were very interested in the charitable grants made from the trusts that they established and, hence, they were consulted.
- 1969 Congress enacts extensive private foundation laws as part of The Tax Reform Act of 1969. Dilemma: Are trusts in bank trust departments separate private foundations even when the community trust controls all of the grant disbursements?
- 1977 The Department of Treasury recognized the unique structure of community trusts and issued tax regulations that gave community trusts the unique advantage of being able to treat multiple trusts and corporations as part of the community foundation ("component funds") rather than as separate organizations. Reg. Sec. 1.170A-9(e)(11)(ii). Any other type of public charity would have to try to have each such trust classified as a "supporting organization" rather than as a part of the charity.
- The regulations contain tests to determine whether *donor advised funds* at community trusts will be component funds or whether they will be separate private foundations. The community trust regulations adopted the *private foundation "material restriction" regulations* to determine whether any given fund qualifies or fails. Those regulations adopt a vague "facts and circumstances" test rather than a bright line legal standard. The regulation lists a series of favorable and unfavorable factors to determine whether a donor had, directly or indirectly, imposed a material restriction on a gift with respect to a donor advised fund. Reg. Sec. 1.507-2(a)(8)(iv)(A)(1).
- 1978 Several universities receive IRS approval to establish donor advised funds, demonstrating that community foundations did not have a legal monopoly on the activity. Private Letter Rulings 7821096 (Feb. 27, 1978) and 7827015 (March 31, 1978) and 8021079 (Feb 28, 1980).
- 1980 New community foundations abandon using the traditional method of having bank trustees establish a trust for each fund. Instead, these community foundations were formed as corporations that directly held and administered contributed property. They established accounts on their books to carry out the charitable purposes specified by the donors.
- 1991 Fidelity Charitable Gift Fund receives IRS approval to operate a national donor advised fund. Each fund is an account rather than a separate trust. Other "commercial" gift funds – donor advised funds affiliated with for-profit financial organizations – spring up.
- 1998 *The Wall Street Journal* reports that distributions from donor advised funds at one charity were made to the children of donors in order to pay them for their volunteer services. In another article concerning a Sec. 509(a)(3) supporting organization, Carl Icahn stated that he, rather than the supported charity, effectively controlled the supporting organization.
- 2000 President Clinton's budget proposal requests a new law for donor advised funds.

- 2002 IRS imposes five conditions for approval of new “commercial” gift funds. An example was the IRS approval of funds at National Fiduciary Services of Houston, Texas:
1. A governing body where the majority could not be affiliated with the bank,
  2. Adopting a policy of a minimum 5% charitable payout (aggregate, not fund-by-fund),
  3. Donors and grantees should be informed that grants may be used only for charitable purposes and not for the benefit of the private donor,
  4. A duty to investigate grants where the bank "has reason to believe that grant funds are being used for the donor's private benefit or other purposes than exclusively charitable purposes, and where such is the case, you will take the necessary steps (including legal action, if necessary) to ensure that the grant is refunded to you or otherwise used for charitable purposes intended by you", *and*
  5. A conflict of interest policy.
- 2003 Tim Mosley receives a five month jail sentence for tax evasion when distributions from his donor advised fund at the National Heritage Foundation were used to pay private school tuition for his child. <http://www.usdoj.gov/usao/can/press/index.html>
- 2004 Newspapers disclose abuses with *supporting organizations*. A repeated scenario: donor businesses set up a supporting organization and contribute large amounts (e.g., \$750,000) and claim a charitable deduction. The next day the donors borrow the money back and give a promissory note for the entire amount. They make interest payments (which they deduct as a business expense) that the supporting organizations immediately distribute as charitable grants. Whereas *private foundations* cannot lend money to donors because of the self-dealing penalty taxes, supporting organizations are public charities that are not subject to private foundations taxes. Supporting organizations are automatically considered public charities because Congress assumed that they were indirectly policed by the publicly-supported charities that they support. Sec. 509(a)(3). When one of the donor businesses failed, the supporting organization’s assets became worthless. The *Chronicle on Philanthropy* identified ten supporting organizations that lent out over half their assets to donors, most of them using the same Salt Lake City attorney. Harvey Lipman and Grant Williams “One Utah Lawyer Helped Create 8 Groups That Lent Money to Donors or Officers” *Chronicle on Philanthropy*, February 5, 2004
- 2004 Senate Finance Committee holds hearings on charitable abuses. Donor advised funds and supporting organizations receive attention.
- 2004 A California Federal District Court reverses its decision to shut down the Xelan Foundation after the IRS uncovered over \$1 million of grants from 22 donor advised funds were used to pay the tuition of the donors’ children. Reason: the foundation had over \$42 million of other assets that were doing good things. Why shut down an entire charity for some abuses? The court suggested that the IRS disallow the charitable income tax deductions claimed by those particular donors rather than shut down the charity. The government was also ordered to pay the charity’s legal defense costs. *United States v. L. Donald Guess et al.*; No. 04 CV 2184-LAB (AJB) (Calif. D.C. Dec. 3, 2004).
- 2005 Senate Tax Bill S. 2020 (later renumbered H.R. 4297) includes provisions to define and regulate donor advised funds and also impose new restrictions on supporting organizations. *Independent Sector* organized the *Panel on the Nonprofit Sector* with representatives from 24 charities to make formal recommendations on such legislation. <http://www.nonprofitpanel.org/final/>
- 2006 New Dynamics court CASE
- 2006 Congress enacts new Sections 4966 and 4967 to regulate donor advised funds as part of The Pension

Protection Act of 2006.

## THE ECONOMIC LANDSCAPE

### -- DONOR ADVISED FUNDS

Donor advised fund assets have experienced phenomenal growth over the past ten years, averaging between 25% and 30% increases every year. Whereas donor advised funds held \$2.4 billion of assets in 1995, by 2003 the estimated total was somewhere between \$13 billion and \$15 billion.<sup>23</sup> The largest administrator of donor advised funds is The Fidelity Charitable Gift Fund, which administers nearly 20% of the nation's donor advised funds and ranks 7<sup>th</sup> in the nation for annual charitable gifts received. In 2005, the Fidelity Charitable Gift Fund administered over \$3 billion of assets in 34,000 donor advised funds and distributed 174,000 charitable grants totaling \$730 million (roughly 24% of its assets) to over 48,000 organizations.

*Grants from donor advised funds now exceed 10% of the grants made by the nation's private foundations.* Whereas endowed private foundations usually distribute the minimum 5%-of-assets that is required by the tax laws, donor advised funds on average distribute nearly a fifth of their assets every year. Donor advised funds at community foundations tend to distribute a slightly smaller portion of their assets (an average that is just under 17%) than funds at the commercial gift funds (an average in excess of over 22%). In 2001, one community foundation distributed less than 2% of its donor advised fund assets whereas another distributed nearly 30%. For commercial gift funds, the comparable range was between 7% to 28%.<sup>24</sup>

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<sup>23</sup> Statement of Jane G. Gravelle of the Congressional Research Service, Senate Finance Committee Hearings on Charities and Charitable Giving: Proposals for Reform (April 5, 2005), page 3. <http://www.senate.gov/~finance/hearings/testimony/2005test/jgtest040505.pdf>

<sup>24</sup> *Id* at page 4.

The range of grant-making among individual accounts was, of course, even wider. One study concluded that 19% of the donor advised funds held by community foundations did not make any charitable distribution in 2003. Nearly 42% of donor advised funds distributed less than 5% of their assets. Thus, a law that would require a minimum distribution of 5% of assets from each donor advised fund could impact over 60% of donor advised funds! Smaller funds were more likely to forego a distribution than larger ones. In 2003, distributions were not made from 21% of the donor advised funds with balances under \$50,000, 25% of funds with balances between \$50,000 and \$100,000, 12% of funds with balances between \$100,000 to \$250,000, and only 7% of funds with balances over \$250,000.<sup>25</sup>

Whereas sizeable administrative costs have effectively made private foundations a grant-making vehicle restricted to the wealthy, the cost advantages of donor advised funds have made them a grant-making vehicle available to the middle-class. Consequently, the assets held in, and the grants made by, donor advised funds tend to be smaller than grants made by private foundations. One study found that 18% of the donor advised funds at community foundations had balances under \$10,000 and 58% had balances under \$50,000.<sup>26</sup>

The average balance of a fund at The Fidelity Charitable Gift Fund was \$80,000 and the average grant in 2005 was \$4,250, but the median figures are lower than the averages. In the author's view, the small asset and grant amounts combined with the sheer volume of grants are important reasons for simpler and clearer laws to regulate donor advised funds compared to the incredibly complex laws that govern private foundations. Only 3% of donor advised funds at community foundations had balances over \$1 million.

## **-- SUPPORTING ORGANIZATIONS**

Whereas donor advised funds can often be established with minimum contributions of just \$10,000, the administrative costs of establishing a supporting organization (tax return, etc.) generally requires a much larger asset threshold. Minimum asset sizes of \$500,000 or \$1 million are common.

Supporting organizations at community foundations have experienced significant growth, but many distribute less than the 5% minimum that would have to be distributed if they were classified as private foundations. "A study of supporting organizations of community foundations indicated that supporting organizations had been growing rapidly: in the entire 1980's 46 were established, while in 1997 and 1998, 92 were established. The study also found that assets of supporting organizations of community foundations accounted for \$ 3.2 billion in assets in 1998, a 50% increase over two years. Most of the assets of these organizations ranged from \$ 1 million to \$ 50 million.

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<sup>25</sup> Foundation Strategy Group, LLC. "Community Foundation Conjoint Study: Donor Advised Funds." Prepared for Council on Foundations, Sept. 15,2003, at [www.foundationstrategy.com](http://www.foundationstrategy.com).

<sup>26</sup> Joanna Sabatini, "Donor Advised Funds Court Advisers," Investment News, June 21, 2004.

"In 2001, the average distribution for the almost 400 organizations with assets over \$ 50 million as a percentage of assets was 8.9%. ... [O]ut of the total, 25% had no payout, 22% had positive payout but less than 3% and 18% had payouts of 3% to 5%. Overall, 65% had either no payout or payouts less than 5%. Most of these organizations, therefore distributed less than the minimum requirement for [private] foundations. There is no way to determine the extent to which these were Type I, Type II or Type III organizations."<sup>27</sup>

## **DEFINITION OF A DONOR ADVISED FUND**

New Code Section 4966(d)(2) DONOR ADVISED FUND-

(A) IN GENERAL- Except as provided in subparagraph (B) or (C), the term `donor advised fund' means a fund or account--

(i) which is separately identified by reference to contributions of a donor or donors,<sup>28</sup>

(ii) which is owned and controlled by a *sponsoring organization*,<sup>29</sup> and

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<sup>27</sup> Statement of Jane G. Gravelle of the Congressional Research Service, Senate Finance Committee Hearings on Charities and Charitable Giving: Proposals for Reform (April 5, 2005), pages 13-14. <http://www.senate.gov/~finance/hearings/testimony/2005test/jgtest040505.pdf>

<sup>28</sup> "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 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." *Technical Explanation of H.R. 4, The "Pension Protection Act of 2006,"* Joint Committee on Taxation, JCX-38-06 (August 3, 2006) at page 342-343.

<sup>29</sup> Code Sec. 4966(d)(1) defines a sponsoring organization as any organization which is described in section 170(c) [i.e., eligible recipients of charitable income tax deductions, though governments are exempt] that maintains 1 or more donor advised funds, except that a private foundation will not be considered to be a sponsoring organization.

(iii) with respect to which a donor (or any person appointed or designated by such donor) has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in such fund or account by reason of the donor's status as a donor.<sup>30</sup>

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<sup>30</sup> “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....

“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 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.” *Technical Explanation of H.R. 4, The "Pension Protection Act of 2006,"* Joint Committee on Taxation, JCX-38-06 (August 3, 2006) at page 343-345.

(B) EXCEPTIONS- The term `donor advised fund' shall **not** include any fund or account--

(i) which makes distributions only to a single identified organization or governmental entity [i.e., a *designated fund* or an *endowment fund*], or

(ii) with respect to which a person described in subparagraph (A)(iii) advises as to which individuals receive grants for travel, study, or other similar purposes ...[if conditions are met].<sup>31</sup> ,

(C) SECRETARIAL AUTHORITY- The Secretary **may exempt** a fund or account not described in subparagraph (B) from treatment as a donor advised fund--

(i) if such fund or account is advised by a committee not directly or indirectly controlled by the donor or any person appointed or designated by the donor for the purpose of advising with respect to distributions from such fund (and any related parties), or

(ii) if such fund benefits a single identified charitable purpose [i.e., a *field of interest fund*, but only if that fund is exempted in regulations to be issued in the future].

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<sup>31</sup> The exemption allows, for example, members of a scholarship selection committee to contribute to the scholarship fund without having the fund be considered a donor advised fund, provided that: "(I) such person's advisory privileges are performed exclusively by such person in the person's capacity as a member of a committee all of the members of which are appointed by the sponsoring organization, (II) no combination of persons described in subparagraph (A)(iii) (or persons related to such persons) control, directly or indirectly, such committee, and (III) 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 of paragraph (1), (2), or (3) of section 4945(g) [the private foundation scholarship provisions]."

**Permissible Grants from A Donor Advised Fund**<sup>32</sup> – Grants to the following grant recipients are permissible:

-- **Any public charity or private *operating* foundation organization, except Type III and other disqualified type I or Type II supporting organizations are ineligible.**<sup>33</sup> The eligible recipients are This includes all public charities and private *operating* foundations. A “functionally integrated” type III supporting organization is eligible, such as the lynchpin supporting organization that often holds together a charitable hospital’s complicated web of affiliated corporations.

-- **The sponsoring organization of the donor advised fund**

– **Any other donor advised fund.** This permits donors to move donor advised funds from one sponsoring organization to another, which can be especially helpful when an individual moves to a new community.

– **A foreign charity or a non-charity organization (e.g., a civic organization or a chamber of commerce), but only if the proceeds are actually used for a charitable purpose.** To qualify for this exception, the sponsoring organization must investigate and verify (“expenditure responsibility”) the charitable use of the funds by meeting the standards that private foundations must meet for comparable grants to avoid the private foundation “taxable expenditure” excise tax. No such Whereas a private foundation could make a grant to an individual under this standard (e.g., a commissioned work of art), a donor advised fund cannot -- the recipient must be an organization.

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<sup>32</sup> Sec. 4966(c)(2).

<sup>33</sup> Sec. 4966(d)(4) describes a disqualified supporting organization as (i) any type III supporting organization (as defined in section 4943(f)(5)(A)) which is not a functionally integrated type III supporting organization (as defined in section 4943(f)(5)(B)), and (ii) a Type I or Type II supporting organization where the donor (or any person designated by the donor) directly or indirectly controls the supported organization.

## **Prohibited Grants from A Donor Advised Fund.<sup>34</sup>**

-- **Taxable Distributions Defined** -- Grants to the following grant recipients are considered taxable distributions:

- any natural person (i.e., a human being),

-- any organization where the proceeds were not actually used for a charitable purpose or where the sponsoring organization of the donor advised fund failed to exercise expenditure responsibility to investigate the use of the grant. As described above, grants to three eligible recipients are exempt from the expenditure responsibility requirement: grants to a public charity or a private *operating* foundation organization (except for Type III or other disqualified supporting organizations), the sponsoring organization of the donor advised fund or any other donor advised fund, or

- any grant for a non-charitable purpose.

## **Penalties on Taxable Distributions --**

### **SEC. 4966. TAXES ON TAXABLE DISTRIBUTIONS.**

(a) Imposition of Taxes-

(1) ON THE *SPONSORING ORGANIZATION*- There is hereby imposed on each taxable distribution a tax equal to 20 percent of the amount thereof. The tax imposed by this paragraph shall be paid by the sponsoring organization with respect to the donor advised fund.

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<sup>34</sup> Sec. 4966(c)(1).

(2) ON THE **FUND MANAGEMENT**- There is hereby imposed on the agreement of any **fund manager**<sup>35</sup> to the making of a distribution, knowing that it is a taxable distribution, a tax equal to 5 percent of the amount thereof. The tax imposed by this paragraph shall be paid by any fund manager who agreed to the making of the distribution.

(2) LIMIT FOR MANAGEMENT- With respect to any one taxable distribution, the maximum amount of the tax imposed by subsection (a)(2) shall not exceed \$10,000.

## **SEC. 4967. TAXES ON PROHIBITED BENEFITS.**

**Automatic excess benefit transactions** – “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 to a donor or donor advisor automatically is treated as an excess benefit transaction under section 4958, with the entire amount 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.” *Technical Explanation of H.R. 4, The "Pension Protection Act of 2006,"* Joint Committee on Taxation, JCX-38-06 (August 3, 2006) at page 347.

**More than incidental benefit - penalty tax - New Sec. 4967 Penalty Tax** – 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 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

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<sup>35</sup> Sec. 4966(d)(3) defines a fund manager as “(A) an officer, director, or trustee of such sponsoring organization (or an individual having powers or responsibilities similar to those of officers, directors, or trustees of the sponsoring organization), and (B) with respect to any act (or failure to act), the employees of the sponsoring organization having authority or responsibility with respect to such act (or failure to act).”

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. *Technical Explanation of H.R. 4, The "Pension Protection Act of 2006,"* Joint Committee on Taxation, JCX-38-06 (August 3, 2006) at page 349-350.

# H.R.4 – The Pension Protection Act of 2006

(Signed into law by President Bush on August 17, 2006)

## COMMITTEE ON WAYS AND MEANS *Detailed Summary of Charitable Provisions*

### CHARITABLE GIVING INCENTIVES

The bill contains a charitable giving incentives package designed to encourage charitable donations.

**1. Tax-Free Distributions From IRAs for Charitable Purposes** - The provision provides an exclusion from gross income for certain distributions of up to \$100,000 from a traditional individual retirement account (IRA) or a Roth IRA, which would otherwise be included in income. To qualify, the charitable distribution must be made to a tax-exempt organization to which deductible contributions can be made. The provision is effective for two years through 2007.

**2. Charitable Deduction for Contributions of Food Inventory** - For donations of food inventory, the provision extends for all trades and businesses an enhanced deduction equal to the lesser of (i) the taxpayer's basis plus one-half of the difference between fair market value and basis, and (ii) twice the taxpayer's basis in the contributed inventory. The provision is effective for two years through 2007.

**3. Basis Adjustment to Stock of S Corporation Contributing Property** - 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. The provision is effective for two years through 2007.

**4. Charitable Deduction for Contributions of Book Inventory** - The provision extends the current-law provision that adds public schools to the list of eligible donees for the enhanced deduction for contributions of qualified book inventory by C corporations. The provision is effective for two years through 2007.

**5. The Tax Treatment of Certain Payments to Controlling Exempt Organizations** - Under current law, rent, royalty, annuity, and interest income paid to a tax-exempt organization by a controlled taxable subsidiary is generally treated as unrelated business income, which is taxable to the tax-exempt parent organization. The provision provides that payments received or accrued by certain exempt parents from taxable controlled subsidiaries will not be treated as unrelated business taxable income. Exempt organizations are required to report certain amounts received from controlled organizations. The provision is effective for two years through 2007.

**6. Qualified Conservation Contributions** - The provision raises the charitable deduction limit from 30 percent of adjusted gross income to 50 percent of adjusted gross income for qualified conservation contributions, provided that such contribution does not prevent the use of the donated land for farming or ranching purposes. The charitable deduction limit is raised to 100 percent of adjusted gross income for eligible farmers and ranchers. The provision allows a taxpayer to carryforward the deduction for 15 years, provided that the taxpayer is a farmer or rancher in the year of the carryforward. The provision is effective for two years through 2007.

**7. Excise Tax Exemption for Blood Collector Organizations** - The provision provides that certain blood collector organizations are exempt from certain excise taxes with respect to activities related to blood

collection.

## CHARITABLE REFORM

The bill contains a charitable reform package designed to responsibly regulate exempt organizations.

**1. Treasury Report on Certain Life Insurance Contracts** - Charitable organizations must report to the Secretary certain acquisitions of interests in certain insurance contracts for two years beginning on the date of enactment. The Secretary is required to issue a report within 30 months after the date of enactment examining if acquisitions of applicable insurance contracts is consistent with the tax-exempt purposes of those charitable organizations that acquire such contracts.

**2. Fines and Penalties Applicable to Charitable Organizations** - The provision doubles the amount of excise taxes applicable to certain activities by charities, social welfare organizations, private foundations and exempt organization managers.

**3. Charitable Contributions of Facade Easements** - Under the provision, a charitable deduction is allowed with respect to easements concerning buildings located in a registered historic district. The easement must provide that no portion of the exterior of the building may be changed or altered in a manner inconsistent with the historical character of the exterior. The provision also clarifies that the charitable deduction is reduced if a rehabilitation tax credit has been claimed with respect to the donated property.

**4. Taxidermy and Substantiation of Exempt Use Property** - The provision limits the basis for donated taxidermy property to the cost of preparing, stuffing and mounting an animal. The value of the deduction would be equal to the lesser of basis or fair market value.

**5. Recapture of Tax Benefit for Charitable Contributions of Exempt Use Property Not Used for an Exempt Use** - The provision provides for the recovery of the tax benefit derived from the contribution of property with respect to which a fair market value deduction was claimed if the property is not used for an exempt purpose of the donee organization.

**6. Clothing and Household Items** - The provision specifies that no deduction is allowed for charitable contributions of clothing and household items if such items are not in good used condition or better. In addition, the Secretary may deny a deduction for any item with minimal monetary value.

**7. Modification of Recordkeeping Requirements for Certain Charitable Contributions** - The provision requires that in the case of a charitable contribution of money, regardless of the amount, the donor must maintain a canceled check, bank record or receipt from the donee organization showing the name of the donee organization, the date of the contribution, and the amount of the contribution.

**8. Partial Interest in Donated Property** - The provision requires that charities receiving a fractional interest in an item of tangible personal property must take complete ownership of the item within 10 years or the death of the donor, whichever is first. In addition, the donee must have (i) taken possession of the item at least once during the 10-year period as long as the donor remains alive, and (ii) used the item for the organization's exempt purpose. Failure to comply with these requirements results in the recapture of all tax benefits plus interest and the imposition of a 10 percent penalty.

**9. Appraisal Reform** - The provision lowers the thresholds for imposing accuracy-related penalties on a taxpayer who claims a deduction for donated property for which a qualified appraisal is required. The provision also applies for purposes of estate tax appraisals and provides definitions of a qualified appraiser and qualified appraisals.

**10. Credit Counseling** - The provision imposes certain requirements on tax-exempt organizations that offer credit counseling services, subject to a four-year transition rule to limit the allowable amount of debt management plan (DMP) income to 50 percent of revenues. In order to stem abusive situations, the provision imposes restrictions on organizations offering credit counseling services with respect to loans, fees, and solicitation of contributions from consumers receiving counseling.

**11. Private Foundation Net Investment Income Excise Tax** - The provision amends the definition of gross investment income to include capital gains, notional principal contracts, annuities, and other substantially similar investment income.

**12. Convention or Association of Churches** - The provision clarifies the definition of a convention or association of churches.

**13. Notification Requirement for Exempt Organizations** - The provision requires certain exempt organizations to file an annual notice with the IRS containing basic contact and financial information. The requirement applies to organizations that currently do not have an annual filing requirement because their gross receipts are less than \$ 25,000.

**14. Encourage IRS Information-Sharing with State Charity Officials** - This provision provides that upon written request by an appropriate state official, the Secretary may disclose information regarding organizations for which the IRS has denied or revoked tax-exempt status, certain other actions the IRS may have taken, and returns filed by tax-exempt organizations.

**15. Public Disclosure of Information Relating to Unrelated Business Income Tax Returns** - The provision extends the present-law public disclosure requirements applicable to Form 990 to the unrelated business income tax returns of Section 501(c)(3) organizations.

**16. Treasury Study on Donor-Advised Funds and Supporting Organizations** - The Secretary will undertake a study on the organization and operation of donor-advised funds and of supporting organizations. The study will include an examination of requirements for determining if such organizations are operating in a manner consistent with the purposes or functions constituting the basis for their tax-exempt status.

**17. Improved Accountability for Donor-Advised Funds and Supporting Organizations** - The provision applies an excess benefits transaction tax on any grant, loan, compensation or other similar payments from a donor-advised fund to a person that with respect to such fund is a donor, donor adviser, or a related person, and from a supporting organization to a substantial contributor or a related person. The provision imposes excess business holdings rules on donor-advised funds and Type III supporting organizations. Transition rules apply to the present holdings of donor-advised funds and supporting organizations. Supporting organizations that are functionally integrated with their charity would not be subject to any excess business holdings rules.

