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"HOW PROTECTING PENSIONS ATTACKED CHARITIES – A VIEW FROM THE FRONT"

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By
Edward Jay Beckwith
Partner
Baker & Hostetler LLP
Washington, D.C.

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I. HISTORY AND SCOPE OF AMERICAN PHILANTHROPY.

A. Historical Perspective.

1. Colonial period – Community-based effort to create a better life.

2. Industrial philanthropy of the late 19th and early 20th centuries (esp. Andrew Carnegie and John D. Rockefeller).

3. Entrepreneurial philanthropy - DotCom millionaires.

B. Scope Of Philanthropy.

1. In 2006, $295 Billion Dollars were Donated to Charitable Causes. Giving USA - 2007.

2. Individuals Gave the Lion's Share (83.4%) - $222.9 Billion (75.6%) in Lifetime Gifts and $22.9 Billion (7.8%) in Bequests.

3. The Rest – Corporations - $12.7 Billion (4.3%) and Foundations - $36.5 Billion (12.4%), respectively.

C. Where The Contributions Go.

1. Religious organizations - $96.8 Billion (32.8%).

2. Educational institutions - $41 Billion (13.9%).

3. Human services - $29.6 Billion (10.0%).

4. Health care - $20.2 Billion (6.97%).

5. Arts, culture and humanities - $12.5 Billion (4.2%).

6. Gifts to foundations (minus unallocated giving) - $29.5 Billion (10.0%).

7. Public/society benefit groups - $21.4 Billion (7.3%).

8. International affairs - $11.3 Billion (3.8%).

9. Environment/wildlife - $6.6 Billion (2.2%).

10. Unallocated Giving - $26.1 Billion (8.8%).

D. The Role Of Tax Benefits.

1. Basic Premise. Our tax laws are so complex that often even the seasoned tax professional does not fully understand the tax aspects of charitable giving. Time learning the area is time well spent. Within the subject are a number of planning opportunities for a wide variety of taxpayers who can help them satisfy their interest in assisting a favorite charity.

2. The Tax Laws Reflect National Policy To Encourage, Impede Or Channel The Use Of Income Or Property.

   a. High estate and gift taxes have made it difficult to pass on the benefits of family assets and business holdings.

   b. Inflation and capital gains taxes result in additional turnover taxes, reducing capital available for the production of future income.

3. The Role Of The Charitable Deduction Under The Tax Laws.

   a. As a matter of national policy, tax savings spur voluntary giving in a pluralistic society.

   b. A charitable tax deduction provides a sharing of cost between the donor and the government.

   c. There is a multiplier effect of increasing funds for charity.

4. Historical Perspective.

   a. Income Tax Deduction. In 1917, only four years after enacting the first income tax, Congress created the charitable contribution deduction. Then, as now, the deduction was subtracted from gross income to determine the base against which tax rates were applied. Despite extensive debate since 1917 about the practical and theoretical underpinnings of the charitable deduction, the scope of the deduction generally has been expanded. However, true fundamental tax reform could have a substantial impact on historic patterns of charitable giving. Study prepared by Council on Foundations and Independent Sector released April 28, 1997.

   b. Transfer Taxes. The Revenue Act of 1918 provided, in part, that the value of the net estate be determined by deducting from the value of the gross estate the amount of all bequests, legacies, devises, or gifts, for religious, charitable, scientific, literary or educational purposes.

E. Planning Basics – Ask Yourself.

1. What Do I Want To Give?

   a. Ordinary Income Property.

   b. Capital Gain Property.

   c. Income in Respect of a Decedent.

2. To Whom?

   a. Public Charity.

   b. Private Foundation.

3. How Is The Gift To Be Arranged?

   a. Outright or in Trust.

   b. Partial Interest.

   c. Benefits to Donor.

   d. Fulfilling a Pledge.

TYPE OF GIFT	DONOR BENEFITS	FAMILY BENEFITS	CHARITY BENEFITS
Outright Gift	Full income tax deduction. No payments to donor.	-0-	Assets available immediately.
Bequest	No income tax deduction. No payments to donor.	-0-	Assets available at some undeter-mined dated in the future.
Gift Annuity	Partial income tax deduction. Annuity payments to donor.	-0-	Assets available immediately, subject to an obligation to make annuity payments.
Charitable Remainder Trust	Partial income tax deduction. Annuity or unitrust payments to donor.	-0-	Assets available in the future, date may or may be fixed.
Charitable Lead Trust	Typically no income tax deduction but income removed from donor's taxable income base. No payments to donor.	Assets available in the future, date may or may not be fixed.	Annuity or unitrust payments to charity.

II. KEEPING DONORS AT THE CENTER OF PHILANTHROPY.

A. Preliminary Considerations.

1. The Donor's Motivation.

2. The Donor's Values.

3. The Donor's Prior Philanthropic Experience.

B. A Myriad of Motivations.

1. It's The Right Thing To Do.

2. Religious Or Family Tradition.

3. Doing Well (In Business) By Doing Good.

4. It Keeps Me Busy And I Enjoy It.

5. Somebody Did It For Me Now It Is My Turn.

C. Philanthropy As A Component Of A Well Craft Plan For A Family's Private Wealth.

1. A Charitable Gift Is Not A Product – It Is Part Of A Comprehensive Process.

2. The Planning Team – Charitable Donees Working With The Donor's Advisors.

3. Developing A Vision: Reflecting A Family's Values – "If You Could Change Just One Thing In The World What Would It Be?"

4. Matching Resources With Needs.

5. Evaluating Potential Charitable Donees.

D. Getting Technical.

1. Determining What, When and How.

2. Component Funds At A Public Charity.

a. Unrestricted Funds.

b. Designated Funds.

c. Field of Interest Funds.

d. Donor Advised Funds.

3. Separate Donor Centered Charitable Entities.

    a. Private Foundations.

        i. Operations.

        ii. Grantmaking.

        iii. Private Foundation rules.

        iv. Limitations of income tax charitable contribution deductions.

    b. Supporting Organizations.

        i. Types.

        ii. Functional integration.

4. Funding Mechanisms.

    a. Outright Gift.

    b. Gifts of Partial Interests.

    c. Life Income Vehicles.

        i. Charitable Remainder Trusts.

        ii. Charitable Gift Annuities.

        iii. Pooled Income Funds.

    d. Charitable Lead Trusts.

5. Fashioning Restrictions.

    a. How Rigid Can They Be? - The Donor's Perspective.

    b. How Rigid Should they Be? - Gift Acceptance Policies.

    c. How Can Restrictions Be Modified or Deferred?

    d. Who Can Enforce Restrictions?

III. REFORMING CHARITABLE ORGANIZATIONS AND CHARITABLE GIVING.

A. For several years, charitable organizations have been a topic of keen interest in Washington and throughout the country. In June of 2004, the United States Senate Committee on Finance released a far reaching *Staff Discussion Draft* of proposals for reform and best practices for tax-exempt organizations. These proposals covered two major areas: reform provisions and governance provisions. The proposals would have impacted the operation and utility of private foundations, donor-advised funds and certain supporting organizations, each a mainstay of donor centered philanthropy. Many of the proposals would have altered the way most charities make decisions about issues as diverse as investing assets and how large, or small, a charity's governing board may be. These proposals were viewed by many as potentially burdensome to charities of all sizes.

B. Various professional and charitable groups responded and at the encouragement of the Senate Finance Committee Chairman and Ranking Member one national organization, the Independent Sector, convened a broad coalition of charities and foundations. That coalition created the Panel on the Nonprofit Sector which was assisted by more than 150 experts and nonprofit leaders. The Panel solicited input from hundreds of other organizations. The Panel issued an Interim Report in March of 2005 and its Final Report in June of 2005. A supplement to the Final Report was issued in April, 2006. These materials are available at www.nonprofitpanel.org. The Reports made recommendations in 15 major areas, including actions to be taken by the nonprofit sector itself, by the IRS, and by Congress. The areas are:

1. Federal and State Enforcement.

2. Internal Revenue Service Reporting.

3. Periodic Review of Tax-Exempt Status.

4. Financial Audits and Reviews.

5. Disclosure of Performance Data.

6. Donor Advised Funds.

7. Type III Supporting Organizations.

8. Abusive Tax Shelters.

9. Non-Cash Contributions:

    a. Appreciated Property.

    b. Conservation and Historic Facade Easements.

    c. Clothing and Household Items.

10. Board Compensation.

11. Executive Compensation.

12. Travel Expenses.

13. Structure, Size, Composition and Independence of Governing Boards.

14. Audit Committees.

15. Conflict of Interest and Misconduct.

C. Remaining Topics.

1. Technical Corrections.

2. Policy Adjustments.

3. Governance Issues.

D. Recent Developments.

1. House. The House Oversight Subcommittee of the House Ways and Means Committee held hearings on July 31, 2007 concerning those provisions of the Act related to tax exempt organizations.

2. Senate. The Senate Finance Committee has issued a discussion draft focusing primarily on nonprofit hospital issues, and the Committee still has a number of outstanding issues, particularly in the governance area, from its original 2004 discussion draft.

3. IRS and Treasury.

IV. THE PENSION PROTECTION ACT OF 2006.

A. Overview.

1. The Pension Protection Act of 2006 ("Act") included a number of provisions that create new or expanded limitations and incentives of keen interest to charitable organizations and their supporters. Overall, the legislation was intended to increase charitable giving while addressing a range of perceived abuses by taxpayers that can lead to excessive tax deductions and by individuals who have involved charities in impermissible ways for their own financial advantage.

2. The legislation is wide-ranging and, in some instances, highly technical in nature. It has impacted the operation and utility of private foundations, donor advised funds and supporting organizations, each a mainstay of donor-involved

philanthropy. Generally, the provisions in the Act were effective for tax years beginning after August 17, 2006 (the date of enactment).

B. Summary of Key Charitable Provisions of the Pension Protection Act.

1. Reforms of Donor-Centered Philanthropy.

a. Incentives for Charitable Giving.

i. Charitable Distributions from IRAs.

(a) Taxpayers who are age 70 1/2 or older were permitted to make tax-free distributions from their IRAs (other than a SEP-IRA) directly to charities up to a maximum of $100,000 per year.

(b) This incentive only applied to direct gifts. Split interest charitable gifts do not qualify.

(c) Distributions to private non-operating foundations, supporting organizations and donor advised funds did not qualify for this tax-free treatment.

(d) Qualifying IRA distributions to charities were treated as part of the donor's IRA minimum distribution requirement but were not included in a donor's taxable income or factor into the charitable contribution deduction otherwise available to the donor.

(e) The incentive only applied to tax years 2006 and 2007, extension is pending.

ii. Enhanced Deductions.

(a) New incentives were added to encourage contributions by business entities of food and book inventories and contributions of capital gain real property for conservation purposes.

(b) Taxpayers who held stock in S Corporations received a more favorable adjustment to the tax basis in their stock when the corporation made a direct charitable contribution of appreciated corporate property to charity.

(c) This incentive also applied only to tax years 2006 and 2007.

iii. Restricted Deductions.

(a) Persons who only give a partial interest in tangible personal property to a charity, such as a fractional interest in an art collection, are now required to fully transfer the property to charity within 10 years.

(b) The tax benefits accorded a donor may be recaptured when tangible property, such as artwork, is contributed to a given charity to be used in furtherance of that charity's exempt purpose and it is not so applied.

(c) Persons who claim deductions for gifts of cash are required to maintain records of such contributions, regardless of amount.

(d) The requirements for reporting and appraising contributed property are stricter.

iv. Tougher rules for record keeping and substantiation of cash contributions.

v. New rules for "taxidermy contributions".

b. <u>Enhanced Enforcemen</u>t. To assure better enforcement and regulatory administration, the Act provides:

i. Organizations that were not previously required to file an annual information return are now required to file a simple form notice with the IRS each year.

ii. Relaxed restrictions on the disclosure of information by the IRS to those state officials charged with policing tax-exempt organizations.

iii. New reporting on acquisitions of interests in certain insurance contracts (including Treasury study on the use of insurance by tax-exempt organizations, due August 17, 2008).

c. <u>Fines and Penalties</u>.

i. The Act lowered the thresholds at which a taxpayer can be penalized for overstating the value of a charitable gift.

ii. Penalty taxes also were doubled for "excess benefit transactions" with public charities--transactions by "disqualified persons" at less than fair market value, the payment of unreasonable

compensation and new "automatic excess benefit transactions" applicable to donor advised funds and supporting organizations, discussed below.

iii. The Act made more restrictive the tax return filing requirements for split interest trusts--charitable remainder trusts and charitable lead trusts.

d. Donor Advised Funds. For the first time there is a legislative definition for what constitutes a permissible donor advised fund. The legislation also provides:

i. All contributed assets have to be under the exclusive legal control of a "sponsoring organization."

ii. Sponsoring organizations are required to document that donors have been fully informed of certain restrictions and limitations applicable to such funds and are subject to additional annual compliance reporting.

iii. Donor advised funds are subject to the private foundation limitations on holdings in business enterprises.

iv. Donors are denied a tax deduction (income, estate or gift) for contributions to a donor advised fund held by a Type III supporting organization ("operated in connection with"). Thus, Type III supporting organizations are no longer appropriate as sponsoring organizations for donor advised funds. This provision was effective for contributions after February 13, 2007.

v. Perhaps most critical, donors and advisors to donor advised funds (and related parties) are now treated as "disqualified persons" and subject to penalty taxes for excess benefit transactions and automatic excess benefit transactions related to transactions with donor advised funds. This provision was effective for transactions after August 17, 2006.

vi. Penalty taxes are imposed on "taxable distributions," defined as distributions (i) to natural persons; (ii) to "disqualified supporting organizations" (Type III and certain Type I and Type II supporting organizations), foreign charities which are not "equivalent" to U.S. public charities and noncharitable organizations (unless expenditures responsibility is exercised); and (iii) for noncharitable purposes.

e. Supporting Organizations. The new rules hit hardest Type III "operated in connection with" supporting organizations, but certain rules impact all supporting organizations.

i. Disqualified persons (donors, trustees, directors, officers and related parties) of Type I, II and III supporting organizations are now treated as disqualified persons with respect to transactions with their supported public charities for purposes of the excess benefit transactions rules. This provision was effective for transactions after July 25, 2006.

ii. Type III supporting organizations eventually are subject to increased minimum distribution requirements and are subject to the same limits as private foundations on their holdings in business enterprises.

iii. There are new limitations on private foundation grants to Type III supporting organizations, effective for grants after August 17, 2006.

iv. New rules apply to Type III supporting organizations in the form of charitable trusts which make annual payments to public charities. As a result of these rules, such charitable trusts likely will be classified as private foundations. There was a one-year transitional rule for existing Type III charitable trusts, thus providing time to reform such trusts, if appropriate.

f. Additional Limitations on Donor Advised Funds and Supporting Organizations.

i. Grants, loans, compensation and other similar payments by donor advised funds or supporting organizations to donors, advisors and related parties are subject to "excess benefit transactions" penalty taxes on the full amount of such payments. Compensation paid to investment managers of donor advised funds is subject to such penalty taxes with respect to the excessive portion of any compensation. These limitations apply to donor advised fund transactions after August 17, 2006 and to supporting organization transactions after July 25, 2006.

ii. Donor advised funds are prohibited from making distributions which provide "a more than incidental benefit" to donors, advisors and related parties.

g. More Rules on the Way!

The Act directed the Treasury Department to conduct a study of supporting organizations and donor advised funds, and to report back to Congress within a year. That study (originally due August, 2007 was not available as this outline went to press) is to specifically consider the following items:

i. Whether income tax, gift tax or estate tax charitable deductions are appropriate for these entities in view of (1) the use of the contributed assets including the type, extent and timing of such use, and (2) the use of the assets of the organization for the benefit of the person making the charitable contribution;

ii. Whether donor advised funds should be required to distribute a specified amount based on income or assets in order to ensure that the sponsoring organization is operating consistent with its exempt purposes and its status as a public charity;

iii. Whether the retention by donors of rights or privileges with respect to contributions to such organizations (including advisory rights or privileges with respective grants or investments) is consistent with pretty such contributions as completed transfers for deduction purposes; and

iv. Whether such issues also arise with respect to other forms of charities or charitable contributions.

h. Private Foundations.

i. Given the new limits on grants by private foundations to Type III supporting organizations, private foundations need to determine if grantees are Type III supporting organizations. Accordingly, supporting organization grantees must be asked for additional information or to provide a certification as part of the acknowledgement process. This has created added administrative burdens which will continue until the IRS expands the information currently provided in the Publication 78 (the list of organizations to which deductible contributions can be made).

ii. A broader reach for tax on net investment income of foundations.

iii. That study could, of course, result in an additional legislation affecting donor advised funds and supporting organizations.

V. WHAT'S A DONOR AND DONEE TO DO?

A. Practical Implications.

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

B. Supporting Organizations.

1. General – Supporting organizations have often been used when a person who might otherwise choose to create a private foundation finds that some aspect of the private foundation environment makes that impractical. A supporting organization may resemble a private foundation in many respects, but because of its relationship with one or more public charities, it is treated as a public charity rather than as a private foundation.

   a. There are three separate types of supporting organizations. They are generally referred to by number as "Type I," "Type II," or "Type III". Type I and Type II supporting organizations have a particularly close relationship with their supported organizations. However, the Type III organization is merely "operated in connection with" its supported organizations.

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

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

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

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

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

3. <u>Excess Business Holdings</u> – Formerly, supporting organizations were sometimes used as a means of holding family business interests in situations where Code section 4943 would prevent a family foundation from doing so. To prevent this, the Act made the excess business holdings rules of Code section 4943 applicable to Type III supporting organizations <u>except</u> those which are functionally integrated. The excess business holdings rules also now apply to Type II supporting organizations if they accept a contribution from a person (other than a public charity) having direct or indirect control of its supported organization. Moreover, if a Type I or Type III supporting organization accepts a gift from such a person, it will be treated as a private foundation <u>for all purposes</u>, until it demonstrates to the satisfaction of IRS that it qualifies as a public charity, other than as a supporting organization.

4. <u>Distributions to Supporting Organizations</u> – In general, private foundations may not count distributions to Type III supporting organizations as qualifying distributions for purposes of the minimum distribution requirement imposed on foundations under Code section 4942, unless the recipient is a <u>functionally integrated</u> Type III supporting organization.

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

a. Existing Supporting Organizations May Need Attention.

i. Clients for whom you set up a supporting organization several years ago may be unaware of the changes. Consider the following situations:

(a) The supporting organization was set up to hold business interests, perhaps as an important part of the client's estate plan.

(b) The founders' family members serve as paid employees of the supporting organization.

(c) The supporting organization has loans outstanding to any disqualified persons (including related business interests).

(d) The Board of Directors of the supporting organization is designed to give the donor(s) a measure of influence that approaches actual control.

ii. The supporting organization structured as a Type III to support a large number of public charities is now a non--functionally integrated supporting organization.

b. Some Supporting Organization Clients May Want Out.

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

(a) Devise a public fundraising plan and achieve sufficient public support to qualify the organization as publicly supported under section 170(b)(1)(A)(vi).

(b) Terminate by transferring all assets to a fund at a public charity, perhaps a donor advised fund.

(c) Terminate by distributing all assets and go out of business.

(d) Become a private foundation. Consider whether local law, the Attorney General, or the IRS may object if the organization seeks to abandon its form as a supported organizations. Private Letter Ruling 1990-52055 involved a supporting organization operated for the benefit of a university. When one of the trustees died,

his widow, who was also a trustee, decided to broaden the purposes of the supporting organization so that it could also serve her other charitable interests. Accordingly, it was proposed to amend the organization's articles of incorporation and bylaws to delete all references to the university as a supported organization, thereby converting it to a private foundation. The university representatives on the board would resign and be replaced by family representatives. Once that had occurred, the organization (which then became a private foundation) would transfer to the university stock with a value estimated at approximately one-half of the foundation's assets. On these facts, the IRS ruled that the organization's classification as a supporting organization would terminate and it would become a private foundation; it would be required to file two separate returns for the year of the conversion -- Form 990 for the period up to the conversion date, and Form 990-PF for the period from the conversion date to the end of its taxable year. The ruling also held that the transfer to the university after the conversion would be a qualifying distribution for purposes of the foundation's minimum distribution requirement under IRC section 4942.

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

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

(a) A 5% (of assets) payout for non--functionally integrated Type III supporting organizations, in place of the existing 85%-of-income standard.

(b) A new rule would limit the number of supported organizations for a new not functionally integrated Type III supporting organization to not more than five. Existing organizations could continue to support more than five if they contribute at least 85% of the new required payout amount to, or for the use of, existing supported organizations.

(c) Quantitative tests, drawn from the existing private operating foundation concepts, would apply to help define functionally integrated Type III supporting organizations.

d. Planning for the New Supporting Organization. Planners will have to consider afresh the utility of a supporting organization for many client situations, such as the business interests, family employees, etc. situations described above.

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

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

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

C. Donor Advised Funds.

1. New Regulatory Structure.

a. In recent years, donor advised funds have proliferated, becoming a popular alternative for a person considering a private foundation. Neither the Internal Revenue Code nor the Regulations, however, provided any definition of donor advised funds or any specific rules governing them. As with any situation in which the rules are unstated or unclear, this absence of specific rules lead to confusion and some abuse. The vast majority of donor advised fund programs were not involved in such abuses and have been only minimally affected by the changes.

b. A donor advised fund is normally a program offered by a public charity to facilitate charitable gifts by individual donors. The public charity is referred to as the "sponsoring organization." It may be a community foundation or other public charity with an independent charitable

program of its own, or it may have no program aside from the donor advised fund operation.

c. The Act creates a statutory definition for donor advised funds and imposes a number of special rules on the foundations falling within the definition.

2. Deductions for Contributions to Donor Advised Funds.

a. No deduction is allowed for a contribution to a donor advised fund unless the sponsoring organization is a qualified charitable organization described in Code section 170(c), other than a private foundation. Thus, contributions to donor advised funds operated by other types of exempt organizations do not qualify for charitable deductions for income tax, gift tax, or estate tax purposes. If the sponsoring organization is a Type III supporting organization, deductions for contributions will be denied unless the sponsor is a functionally integrated Type III supporting organization, as discussed above.

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

3. Automatic Excess Benefit Transactions.

a. The Act effectively prevents any grant, loan, compensation, expense reimbursement or other similar payment from a donor advised fund to a donor, donor advisor, or related persons. Any such payment is automatically treated as an excess benefit transaction under the intermediate sanctions rules, Code section 4958. Regardless of the facts, the tax will be imposed upon the full amount paid.

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

c. For example, what if a donor contributes securities to a donor advised fund, the donor advised fund distributes them to the sponsoring

organization, and the donor then purchases the securities from the sponsoring organization. Under such circumstances, the distribution to the sponsoring organization will be ignored, so that the purchase from the sponsoring organization will be subject to tax under Code section 4958.

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

4. Excess Business Holdings.

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

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

5. Private Benefit. If a donor, a donor advisor or a person related to the donor or the donor advisor provides advice which results in a direct or indirect benefit, that is more than incidental that individual can be subjected to an excise tax equal to 125 percent of the amount of the benefit. Citing Rev. Rul. 80-77, 1980-1 C.B. 56 and Rev. Proc. 90-12, 1990-1 C.B. 471 the explanation of the Joint Committee on Taxation provides that a benefit is more than incidental "… 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."

6. Practical Implications.

a. Most responsible donor advised funds operate in basically the matter dictated by the new rules. For example, donors to traditional funds were

not given an opportunity to receive grants, loans, or compensation, or to contribute business interests or other problematic assets prior to the Act.

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

i. Private Benefit – Be Cautious! – Private benefit rules can have some unexpected effects. For example, some community foundations allow donors to bifurcate some contributions, such as the cost of tickets to a fund-raising dinner or other event. In such instances, the donor may advise a grant from his/her donor advised fund account to pay the portion of the ticket cost that would be deductible if paid directly, but write a personal check for the value of the non-deductible part. Unless and until the IRS clarifies this, such a practice should be approached with caution.

ii. Donors -- Check Your Receipts – The receipt for a contribution to a donor advised fund now must include language warning that the sponsoring organization has exclusive legal control over the assets contributed.

iii. More Rules on the Way! -- The Act directed the Treasury Department to conduct a study of donor advised funds. When that report is released, it could result in an additional legislation that may establish additional restrictions on donor advised funds and their contributors. See Page 13 above.

iv. Donor Advised Fund vs. Family Foundation – Just as the new rules imposed under the Act affect the viability of supporting organizations as alternatives to donors considering a private foundation, the new donor advised funds may have some impact on donors as well. However, the typical donor is not as intimately involved with the operations of the donor advised fund, and is thus not as likely to encounter disappointment under the new rules. In fact, many clients who formerly chose a supporting organization may wish to terminate that and distribute the remaining assets to a donor advised fund.

D. Private Foundations May Be Looking Better.

1. Private foundations formerly had more restrictive operating rules and limitations on donors' deductions than any other category of charity. The Act changes this balance, and some donors may find that private foundation status is preferable to continued existence as a supporting organization, while others may find that a donor advised fund brings restrictions they would rather avoid.

2. The principal change in the rules governing private foundations was a simple doubling of all of the initial taxes imposed under the Chapter 42 penalty provisions, plus a doubling of the maximum exposure of foundation managers for several the taxes.

Chapter 42 Initial Tax Rates

	Former Law	New Law
Self-dealing (section 4941)		
Initial tax on self dealer	5%	10%
Initial tax on foundation manager	2_ %	5%
Failure to distribute income (section 4942)		
Initial tax	15%	30%
Excess business holdings (section 4943)		
Initial tax	5%	10%
Limits on foundation managers (per investment)		
Initial tax	$5,000	$10,000
Additional tax	$10,000	$20,000
Jeopardy investments (section 4944)		
Initial tax	5%	10%
Taxable expenditures (section 4945)		
Initial tax on foundation	10%	20%
Initial tax on foundation managers	2_ %	5%
Limits on foundation managers		
Initial tax	$5,000	$10,000
Additional tax	$10,000	$20,000

3. Most of the changes in the Act did not effect the average family foundation:

   a. Doubled Penalties – This shouldn't be a problem, since the goal always is to avoid the penalties in the first place.

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

i. *Type I, II, and functionally integrated Type III supporting organizations*. Private foundations may make distributions to Type I, Type II, or functionally integrated Type III supporting organizations; these distributions count as part of the foundation's qualifying distribution amount for the year. However, if a disqualified person to the foundation controls the Type I, Type II, or functionally integrated Type III supporting organization, or if that disqualified person controls a supported organization of that supporting organization, the foundation must exercise expenditure responsibility.

ii. *Type III non-functionally integrated supporting organizations*. Private foundations may also make distributions to Type III supporting organizations that are not functionally integrated so long as they exercise expenditure responsibility. However, these distributions are not considered qualifying distribution for the purposes of the foundation's annual required distribution amount, and are considered a taxable expenditure if the foundation does not engage in expenditure responsibility.

VI. PROPERTY CONTRIBUTIONS AFTER THE PENSION PROTECTION ACT.

A. Excessive valuation claims for charitable contributions of property has been a potential problem since the creation of the charitable deduction. Despite tightening of the valuation rules over the years, particularly with the imposition of the qualified appraisal requirement, notification to IRS on disposition of contributed property by the donee (so-called "tattletale" rule), and ever-increasing penalties, this subject remains a point of concern for the IRS.

B. The Act changed several property contribution rules:

1. Recapture of Tax Benefit on Property Not Used for an Exempt Use.

a. Since 1969, the Code has provided that a contribution of tangible personal property is reduced if the property is used by the donee in a manner unrelated to the donee's exempt purpose. In general, the amount of such a contribution is the taxpayer's basis in the property rather than the property's fair market value.

b. The Act added a new rule recapturing the donor's tax benefit where tangible personal property is contributed and a fair market value deduction in excess of $5,000 is claimed, but the donee somehow fails to put the property to a use related to its charitable purpose, the portion of the deduction in excess of basis is subject to recapture. If the donee disposes of the property within three years of its contribution, an amount equal to any excess of the deduction claimed over the donor's basis is added to the donor's income for the year in which the disposition occurs.

Also, the length of time during which the donee is required to report dispositions of contributed property (the tattletale rule) is extended from two years to three years.

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

2. Fractional Interests in Tangible Personal Property.

a. A standard planning technique for contributions of valuable items of tangible personal property (such as artwork) is a gift of a fractional interest in the property. The Tax Court approved this concept, and allowed a deduction (even when the donee failed to take possession of the property as required by the regulations), provided the donee organization had the legal right to claim the property for its fraction of the year. See *Winokur v. Commissioner*, 90 TC 733 (1988), acq. 1989-2 CB 1.

b. The Act continues to permit such deductions but makes two important changes, the net effect of which is to render use of this technique dangerous. First, the donor's charitable deduction (for income tax and gift tax purposes) will be recaptured, plus interest, plus a 10% penalty, if any one of three conditions exists:

i. If, after making an initial fractional contribution, the donor or fails to contribute all of his or her remaining interest in the property to the same donee within 10 years (or before the donor's earlier death);

ii. If the donee fails to take substantial physical possession of the property during the period described; or

iii. If the donee fails to use the property for an exempt use during that period, the donor's deductions under the income tax and the gift tax for all previous contributions will be recaptured (plus interest).

c. Another new rule imposes a special valuation limitation on contributions of partial interests in tangible personal property. For all tax purposes (income tax, gift tax and estate tax), any subsequent contributions of an interest in the same property must be based on the value of the property at the time of the initial contribution. Thus, if the property appreciates in

value after the initial contribution, this increase will not benefit the donor's deductions for subsequent contributions. (However, if the property has gone down in value, the value at the time of the subsequent contribution will govern.)

d. This valuation feature can make it extremely hazardous to undertake a series of partial interest gifts.

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

e. The Technical Corrections Act of 2007 limited the valuation rule to income tax deductions for contributions. For gift tax and estate tax purposes, that Act repealed the PPA valuation rule retroactively. Thus, for gifts and bequests, the deduction for partial interests in tangible personal property will continue to be equal to the applicable percentage of the actual fair market value of the contributed property.

3. Clothing and Household Items.

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

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

C. Taxidermy Property.

1. The Act prescribed new rules for contributions of "taxidermy property." This category is defined as including any work that –

    a. Is the reproduction or preservation of an animal in whole or in part;

    b. Is prepared, stuffed or mounted for purposes of re-creating one or more characteristics of such animal; and

    c. Contains a part of the body of the dead animal.

2. When the contribution is made by the person who prepared or paid for the preparation of the property, the deduction is limited to the lesser of basis or fair market value. In determining basis for this purpose, the only amounts taken into account are the costs of preparing stuffing or mounting; indirect costs such as costs, hunting, travel, etc. are not included.

D. Conservation Easements – The Act created several new incentives to encourage contributions of capital gain real estate for conservation purposes. Instead of the usual 30%-of-AGI limitation, qualified conservation contributions now are subject to a 50%-of-AGI limit, with any excess carrying over for 15 years instead of the usual five. In the case of a qualified farmer or rancher, the percentage limitation is increased to 100% of AGI, also subject to a 15-year carryover. However, these provisions expire December 31, 2007.

The Act also revised the rules for qualified conservation contributions relating to property located in a registered historic district. Easements protecting such property continue to be deductible, but several additional requirements apply.

1. The portion of the easement relating to the exterior of the building must preserve the entire exterior of the building, including the space above the building, the side, the rear, and the front of the building.

2. The easement must provide that no portion of the exterior of the building may be changed in a manner inconsistent with the historical character of the exterior.

    a. Returns claiming such a deduction must include considerable new information, describing all current restrictions on development, etc., and the donor's deduction will be disallowed if this information is not provided.

    b. A taxpayer claiming a deduction in excess of $10,000 for a conservation contribution involving the exterior of a building located in a registered historic district must pay a $500 fee to IRS.

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

1. The threshold for imposing accuracy-related penalties for overstatement of the value of property contributions is lowered from 200% (of the true value) to 150%, the gross valuation misstatement threshold is lowered from 400% to 200%.

2. Penalties on understatement of values for estate tax against tax purposes are similarly beefed up. In general, there is a substantial penalty if the valuation reported is 65% (formerly 50%) or less of the correct value, and a gross understatement is present, if the value is 40% (formerly 25%) or less.

3. The accuracy-related penalties formerly did not apply if the taxpayer showed there was reasonable cause and he or she acted in good faith. The Act eliminates this exception for gross misstatements.

4. Appraisers are subject to increased oversight under the Act. A civil penalty of the greater of $1,000 or 10% of the understatement resulting from a valuation misstatement (up to a maximum of 125% of the gross income derived from the appraisal) applies to a person who prepares an appraisal that results in a valuation misstatement. The disciplinary rules for appraisers also were expanded. The IRS no longer needs to apply a civil penalty before it can discipline appraisers by suspending or barring them from appearing in tax matters.

F. Qualified Appraisers. In addition, the definition of qualified appraiser was expanded to require verifiable education and experience in valuing that type of property for which the appraisal is being performed.

G. Cash Contributions – even a simple thing like a charitable contribution of money was made more complicated by the Act. Formerly, a canceled check, a receipt, or "other reliable written records" were sufficient, but under the Act," other written records" alternative is repealed. Thus, if a donor does not get a receipt, it will be necessary to obtain a bank record substantiating a cash contribution.

H. Working with the New Rules.

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

2. Much of the potential difficulty faced in working under the new rules can be minimized, if not avoided entirely, simply by keeping those rules in mind:

a. Fractional Interests in Tangible Personal Property – While this has been a useful technique for many years, the changes in the Act make it unwise to undertake such a gift program today unless there is virtually no possibility that the property in question will appreciate in value (which is unlikely).

b. New Focus on Exempt Use – A donee organization's use of contributed tangible personal property will now have to be monitored closely, not just at the time of contribution but for at least three years. Advisers must avoid the temptation to secure the donee's agreement to postpone sale or other transfer until the tattletale period (now three years) has expired.

c. Taxidermy Contributions – It Wasn't Broken, But Now It's Fixed – No competent advisor would have signed off on a client's participation in the transaction that gave rise to this unnecessary rule. Nevertheless, we now have a firm basis for advising such a client against participation.

d. Clothing and Household Items – Although not usually a contribution on which an advisor's advice is sought, donors can avoid potential tax problems by being reasonable and realistic in valuing such property, and assuring that a zero deduction is taken on anything that is not in "good used condition or better".

e. Nothing Lasts Forever -- The incentive provisions of the Act all expired on December 31, 2007. Efforts to extend these provisions are underway, and an extension was included in the President's Budget Proposals but the outlook is unclear. Clients who may be interested in making charitable contributions from their IRA account, or taking advantage of the liberalized rules for contributions of conservation easements should watch for future developments. Particularly in the case of the easement transactions, the negotiation and drafting aspects of the contribution can be quite time consuming. The incentives may be extended, but then again they may not, and even if they are extended that may not happen for several months.

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