

**COMMENTS ON PROVISIONS RELATING TO TAX-EXEMPT
ORGANIZATIONS IN THE PENSION PROTECTION ACT OF 2006**

These comments (the “comments”) are submitted on behalf of the American Bar Association Section of Real Property, Probate and Trust Law. They have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and should not be construed as representing the position of the American Bar Association.

The comments were prepared by members of the Charitable Planning and Organizations Group (the “Group”) of the Probate and Trust Division of the Real Property, Probate and Trust Law Section of the American Bar Association. Principal responsibility was exercised by Carol G. Kroch of Wilmington Trust Company, Group Chair-Elect, Mary Lee Turk of McDermott Will & Emery, Group Vice Chair-Elect, Christopher R. Hoyt of University of Missouri (Kansas City) School of Law, David J. Dietrich of Dietrich & Associates, P.C., and Jarrett T. Bostwick of Handler, Thayer, & Duggan, L.L.C. Linda B. Hirschson of Greenberg Traurig LLP reviewed the comments on behalf of the Section’s Committee on Governmental Submissions.

Although members of the Group who participated in preparing the comments have clients who are affected by the federal tax principles addressed, or have advised clients on the application of such principles, no such member or the firm or organization to which such member belongs has been engaged by a client to make a governmental submission with respect to, or otherwise influence the development or outcome of, the specific subject matter of the comments.

Contacts:

Carol G. Kroch
Phone (302) 651-8928
ckroch@wilmingtontrust.com

Mary Lee Turk
Phone (312) 984-3280
mturk@mwe.com

Date: August 3, 2007

EXECUTIVE SUMMARY

These comments respond to the June 12, 2007 Advisory of the Subcommittee on Oversight of the Committee on Ways and Means of the United States House of Representatives requesting written comments on the provisions of The Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780 (2006) (the “PPA”) relating to tax-exempt organizations.

These comments make the following points: (1) the PPA provisions allowing charitable IRA rollovers for individuals over age 70 ½ are valuable to the charitable sector and should be extended permanently and expanded to allow gifts to DAFs, SOs and private foundations; (2) the PPA provisions requiring an S corporation shareholder to reduce the basis of his or her stock only by the shareholder’s pro rata share of the adjusted basis of the property donated by the S corporation appropriately treats S corporation shareholders the same as partners and should be extended permanently; and Congress should also clarify the permitted deduction when the basis of an S corporation shareholder’s stock is less than the shareholder’s pro rata share of the charitable contribution; (3) the PPA provisions increasing the percentage limitations for qualified conservation contributions should be made permanent and the definition of gross income for purposes of determining whether a farmer or rancher qualifies for the 100% limitation should be clarified and broadened; (4) an overly broad and unclear definition in the PPA of a donor advised fund (“DAF”) should be clarified as it has caused significant administrative costs and confusion for charities administering both DAFs and other charitable funds; (5) the PPA provisions applying the excess business holdings rule to DAFs and supporting

organizations (“SOs”) have unnecessarily curtailed charitable gifts by owners of closely held businesses; (6) Section 1218 of the PPA has not only reduced the income tax incentives to make gifts of fractional interests in tangible personal property, but has also created estate and gift tax liability for fractional contributions of appreciated property that should be eliminated; (7) the PPA provisions addressing contributions to certain SOs may have a chilling effect on a charity’s access to funds; (8) the PPA may go too far in its application of the excess benefit rules to DAFs and SOs, resulting in an inconsistent application of such rules and a departure from normal commercial practices; and (9) we welcome the PPA’s endorsement of minimum distribution rules for SOs and believe that minimum distribution rules similar to those currently in effect, when coupled with increased disclosure, may provide a compromise between the Treasury Department’s need to monitor SOs with the charitable sector’s need for sources of support; however we suggest that Congress reconsider the necessity for and effectiveness of minimum distribution rules based on a percentage of an SO’s income or assets.

DISCUSSION

I. PROVISIONS SCHEDULED TO EXPIRE ON DECEMBER 31, 2007

As a preliminary comment, we note that it would provide stability and certainty to the tax law to extend permanently all three provisions discussed below.

A. Charitable IRA Rollover. Section 1201 of the PPA permitted individuals over age 70 ½ to make lifetime charitable gifts of up to \$100,000 per year in 2006 and 2007 directly from an IRA to a public charity (other than a supporting organization or a donor advised fund).

1. Importance to Charities. This provision was an important legislative change sought by the nation’s charities and should be extended permanently. Further, we suggest that Congress consider permitting donors to make gifts from their IRAs to DAFs, SOs and private foundations. If the law is made permanent, IRA administrators and charities will likely take steps to cure the technical problems they have encountered in implementing the current legislation.

2. Problem In the Year That an IRA Owner Attains Age 70 ½. If the law is extended to future years, the age for eligibility should be more closely coordinated with applicable retirement plan distribution rules. Currently the charitable IRA distribution rules discriminate against people born in the months of May and June. For example, a person who was born on June 27 will attain age 70 ½ on December 27. 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 from an IRA, but only distributions made on or after December 27 qualify for the charitable IRA exclusion. The legislation should be changed for 2007 and for future years to conform the charitable exclusion with the minimum distribution requirements. Thus, if the eligible age remains 70 ½, then all distributions should qualify for the charitable exclusion if made “within the calendar year that the individual for whose benefit the plan is maintained has attained age 70 ½.” This change would simplify the administration of this provision and ensure that innocent parties are not caught in a tax trap. If, however, future legislation lowers the eligible age to 59 ½ (as is proposed for deferred gifts in H.R. 1419 and S. 819, “The Public Good IRA Rollover Act of 2007”), then requiring qualifying IRA distributions to be made on or after the date the donor turns 59 ½ is appropriate as it would mirror the 10% early distribution penalty provision of I.R.C. Sec. 72(t).

B. Charitable Gifts of Appreciated Property by S Corporations. Section 1203 of the PPA permitted charitable gifts of appreciated property made by S corporations to have similar tax consequences to comparable charitable gifts made by partnerships and limited liability companies

("LLCs"), but only for gifts made in 2006 and 2007. In the past, the shareholders of an S corporation had to reduce their basis in their stock by the full deduction for the appreciated value of the property, whereas the basis in the ownership interest of a partnership or an LLC was reduced by only the cost basis, consistent with partnership tax theory. Partnership tax treatment for both forms of enterprise is important. It is especially significant for an S corporation, since a shareholder's basis in his or her stock is typically lower than that of a comparable partnership or LLC ownership interest. Whereas partnership tax law permits partners and LLC members to increase their tax basis by their share of the business' debts, S corporation shareholders cannot increase their basis by their share of the corporation's liabilities.

Many shareholders with a low basis in their stock are under the impression that I.R.C. Sec. 1366(d)(1) prohibits them from claiming a charitable income tax deduction that exceeds the basis of their stock, which discourages charitable gifts from S corporations. In his letter of June 28, 2007 to Treasury Secretary Paulson, Senator Richard Lugar stated that "the intent was that the full benefit of the deduction be conferred upon those shareholders." We recommend that the PPA basis reduction rule be made permanent and that Congress clarify the amount of the deduction permitted S corporation shareholders whose basis in their stock is less than their pro rata share of the amount of the charitable contribution otherwise deductible.

C. Charitable Gifts of Conservation Easements. The PPA and I.R.S. Notice 2007-50, "Guidance Regarding Deductions by Individuals with Qualified Conservation Contributions," expand and clarify the availability of qualified conservation contributions. However, several significant questions require clarification.

1. Make the Law Permanent. We believe the expanded deduction limitations of 50% under I.R.C. Sec. 170(b)(1)(E)(i) and 100% under I.R.C. Sec. 170(b)(1)(E)(iv) for qualified farmers and ranchers should be made permanent. The grant of a perpetual conservation easement by a farmer or rancher is likely his or her most significant financial transaction short of outright sale; yet the law "sunset" on December 31, 2007. Many conservation easements take the form of perpetual "management plans" for agricultural land owners and can take significant amounts of time to negotiate because of their perpetual duration. Although the provision does not sunset until December 31, 2007, as a practical matter, it will be difficult for donors who have not already commenced negotiations even to donate a conservation easement in 2007.

2. The Definition of Gross Income Does Not Conform to the Calculation of Gross Income From Farming Otherwise Used in the Tax Code The definition of gross income under I.R.C. Sec. 170(b)(1)(E) remains ambiguous. I.R.C. Sec. 170(b)(1)(E)(v) provides that an individual is a qualified farmer or rancher if the individual's gross income from the trade or business of farming (within the meaning of I.R.C. Sec. 2032A(e)(5)) in the taxable year of the contribution is greater than 50% of the individual's total gross income for the taxable year of contribution. I.R.C. Sec. 2032A(e)(5), however, does not define gross income from the trade or business of farming; rather it provides a definition of "farming purposes" for purposes of alternate valuation under the estate tax. The agricultural activities listed in I.R.C. Sec. 2032A(e)(5) are significantly narrower than the broad definition of farming used throughout the Internal Revenue Code to define income and deductions in calculating gross income from farming. See I.R.C. Sec. 61 and the Farmer's Tax Guide (IRS Publication 225). We suggest that the taxpayer's "gross income from the trade or business of farming" for purposes of I.R.C. Sec. 170(b)(1)(E)(v) should be the same as gross income from farming for income tax purposes generally, as shown on Form 1040, Schedule F, line 11 or line 51, with the addition of gross income (not gain) from forestry and from sales of livestock and other farm products reported on Form 4797.

3. Other Traditional Agricultural Income Sources Should Comprise Gross Income. We recommend that rental income and income from caring for another's livestock, farm program payments, the sale of livestock, conservation reserve program payments, hunting and fishing and the sale of farm products

not held primarily for sale should constitute “gross income from the trade or business of farming” under I.R.C. Sec. 170(b)(1)(E)(v). Many agricultural operations have established corporations or LLCs to hold real estate separate from the active operations conducted by a distinct corporation or LLC that owns the livestock, equipment and machinery, with a rental agreement between the two business organizations. Excluding such rental income from the definition of gross income from farming under I.R.C. Sec. 170(b)(1)(E)(v) effectively removes significant tracts of agricultural farming and ranching real estate from qualification for the expanded 100% deduction limitation even though the property is actually used for farming.

4. Reconsider Deduction Limitations for Easements Donated by Non-Publicly Traded C Corporations. Although I.R.C. Sec. 170(b)(2)(A) limits a charitable contribution deduction by a C corporation to 10% of taxable income, under new I.R.C. Sec. 170(b)(2)(B)(i) the deduction limitation for a gift of a qualified conservation easement is expanded to 100% of taxable income (reduced by other allowable charitable deductions) for certain C corporations. The higher limit is available to a non-publicly traded corporation that is a qualified farmer or rancher, and which donates an easement restricting the property to agricultural or livestock production. We note that if the C corporation fails to meet the gross income test for a qualified farmer or rancher, it loses the expanded limitation, whereas if an individual donor fails to meet the definition of a farmer or rancher, an enhanced deduction limitation of 50% of adjusted gross income (rather than 30%) is still available. If Congress wishes to encourage contributions of conservation easements by nonpublicly traded C corporations, it could consider adopting a similar enhanced deduction limitation for gifts of conservation easements by C corporations that do not qualify as farmers or ranchers.

II. DONOR ADVISED FUNDS

A. Burdens on Charities that Administer DAFs and Also Engage in Other Charitable Activities. The PPA generated substantial administrative and compliance costs to charities that administer both DAFs and other charitable funds, especially geographic and religious community foundations. They, like virtually all non-profit organizations, use “fund accounting.” They record each restricted gift in a separate fund. Many charities have gone through the extensive and arduous task of examining each and every fund agreement to determine whether it is a DAF or not.

Their problem has been exacerbated by the absence of guidance for ambiguous situations. The definition of a DAF is so broad that it could potentially include every restricted gift where there is any continuing donor involvement. For example, one would normally not think that an endowed chair at a university foundation is a DAF. If, however, the assets are invested by an investment firm where the donor’s son is employed, is the endowed chair a DAF? A DAF exists when a donor or related party advises either with respect to distributions or investments. I.R.C. Sec. 4966(d)(2)(A)(iii).

We suggest that Congress amend the PPA provisions to appropriately narrow the definition of a DAF or clarify when certain common kinds of funds, such as those with restricted charitable purposes, are excluded from the definition of a DAF. We also urge Treasury to exempt from the definition of a DAF a fund that is advised by a distribution committee that is not directly or indirectly controlled by the donor or the donor’s appointee, as is authorized by I.R.C. Sec. 4966(d)(2)(C). We further suggest that funds established by local governments and publicly-supported charities at community foundations be excluded from the definition of a DAF. These entities should be able to recommend charitable grants from such funds with the same freedom as if they had directly made the disbursements themselves.

B. Repeal of Penalty if Additional Language Missing in Acknowledgment to Donor. The PPA amended I.R.C. Sec. 170 to deny a charitable income tax deduction for a contribution to a DAF unless the charity’s acknowledgment to the donor specifically states that the sponsoring organization “has exclusive legal control over the assets contributed.” I.R.C. Sec. 170(f)(18). Until this provision was enacted, the law governing every charity’s written acknowledgment to every donor had a uniform standard. I.R.C. Sec.

170(f)(8). The new DAF provision needlessly complicates the law and the punishment is excessive. Every completed charitable gift requires a transfer of legal control, including a gift to a DAF. Furthermore, the definition of a DAF is so broad (see above) that both the donor and the charity might not realize that a simple restricted gift agreement fell within the definition of a DAF. A donor should not lose a tax deduction solely because the charity's receipt did not contain this statement. We recommend repeal of this provision, or in the alternative, the imposition of a reasonable fine on the charity (the party responsible for issuing the statement) similar to the penalty for a charity's failure to send a donor a written acknowledgment of any kind: \$10 per contribution, capped at \$5,000. I.R.C. Secs. 6115 and 6714.

C. The Excess Business Holdings Rules Have Curtailed Gifts of Closely-Held Business Interests to Both DAFs and SOs. This subject is addressed in Par. IV C. below.

D. The Penalty for an Excess Benefit Transaction With a DAF Applies Even to the Portion of the Reasonable Value of Services Rendered. The PPA classified the *entire* amount of any grant, loan, compensation, or similar payment from a DAF to a donor or related party as an "excess benefit payment", whereas normally only the *excess* over the value of services is subject to that tax. Compare I.R.C. Sec. 4958(c)(2) and (c)(1), and I.R.C. Sec. 4941(d)(2)(E). We question why reasonable compensation is not permitted when both public charities and private foundations can make such payments to disqualified persons. If a financial institution seeks to establish a DAF, or if a donor recommends an investment firm where a family member is employed, an exemption seems appropriate if the investment firm's fees are reasonable and comparable to fees that it charges other customers. This issue is addressed in greater detail in Par. IV D. below.

III. GIFTS OF FRACTIONAL INTERESTS IN TANGIBLE PERSONAL PROPERTY

Section 1218 of the PPA made significant changes to the income, estate, and gift tax consequences of donations of fractional interests in tangible personal property to charitable institutions ("fractional contributions").

A. Overview of Changes. Under prior law, a fractional contribution was deductible for federal income tax purposes, if the donee 1) received an undivided portion of the donor's entire interest in the property gifted, I.R.C. Sec. 170(f)(3)(B)(ii); and 2) had the right to possession, dominion, and control of the property proportionate to its ownership interest. Treas. Reg. §1.170A-7(b)(1)(i); Winokur v. Commissioner, 90 TC 733 (1988). Like other charitable gifts of tangible personal property, a fractional contribution was valued for income, estate, and gift tax purposes at its full fair market value at the time of the gift. For estate and gift tax purposes, fractional contributions were deductible at the full fair market value, I.R.C. Secs. 2055 and 2522, and for income tax purposes they were deductible at the full fair market value of the gift, if the use of the property by the donee charity was related to its charitable purpose, I.R.C. Sec. 170(e)(1)(B), subject to the applicable percentage of contribution base limitations. I.R.C. Sec. 170(b). We are aware that in some circumstances donors took advantage of these rules, but we are concerned that the PPA has not only reduced the income tax incentives to make valid fractional contributions, but has established estate and gift tax penalties on fractional contributions of appreciated property.

The PPA established a new regime for fractional contributions, providing: (i) unique valuation rules for income, estate, and gift tax purposes; (ii) deadlines for donating the remaining fractional interest in the property, enforced by recapture and penalty provisions; (iii) a new requirement that the donee charity have substantial possession of the donated property, also enforced by recapture and penalty provisions; (iv) unrelated use recapture rules more onerous and punitive than those the PPA introduced for non-fractional contributions; and (v) narrow ownership requirements for donors to obtain deductibility.

B. New Valuation Rules. In our view, the most serious change is caused by the new valuation rules. New I.R.C. Secs. 170(o)(2), 2055(g), and 2522(e)(2) limit the charitable deduction for subsequent fractional contributions to the lesser of the fair market value of the property at the time of the initial fractional contribution or at the time of the additional contribution. Thus, the donor is denied an income, estate, or gift tax deduction for the value of any appreciation of the property since the time of the initial fractional contribution. The denial of the income tax deduction in these circumstances may be a disincentive to some taxpayers, and it is not clear why the deduction should be limited if the gift otherwise meets the requirements for fractional contributions. However, the most severe consequences arise under the estate and gift tax, as shown by the following example:

In 2007, D contributes an undivided one-half interest in a painting with a fair market value of \$2 million to an art museum providing for the museum to have possession of the painting for 6 months each year. D's income tax deduction, based on fair market value, is \$1 million. A similar gift tax deduction applies, so that no gift tax is due on the fractional contribution. In 2015, when the painting has appreciated in value to \$4 million, D makes the final fractional contribution of the painting to the museum. Under the new PPA limitations, D's income tax deduction is only \$1 million, even though the value of the subsequent fractional contribution is double that amount. More seriously, however, D has made a charitable gift of \$2 million, but is entitled to a gift tax deduction of only \$1 million. Under the 2007 gift tax rates of 45%, D has an actual cost (either a reduction of D's applicable exclusion amount, a gift tax liability or a combination of both) of approximately \$450,000 for making a gift to charity! Similarly, if D died in 2015 and made a testamentary fractional contribution, the value of the appreciation since the initial fractional contribution would be includable in D's estate.

Denying an income tax deduction for the appreciation in value of tangible personal property since the initial fractional contribution reduces an offset against taxable income. Denying a gift or estate tax deduction for the appreciation results in a tax on a gift to a charity, which is not only punitive in nature but is an unprecedented departure from the general transfer tax approach to charitable gifts. If Congress did not intend such a draconian result, we suggest it be eliminated by the repeal of new I.R.C. Secs. 2055(g) and 2522(e)(2).

C. Deadline for Contributions of Remaining Interest. The PPA requires a donor to give the remaining fractional interest in the donated property before the earlier of 10 years after the date of the initial fractional contribution ("the 10 year period") or the date of the donor's death. If this requirement is not met, the income and gift tax deductions for the initial fractional contribution will be recaptured and subject to interest and a 10 percent penalty. I.R.C. Sec. 170(o) and 2522(e). As a technical matter, if a donor dies before the end of the 10 year period, and makes a final fractional testamentary contribution, such gift will not have been made BEFORE the donor's death. We suggest amending this provision to require the gift to be made on or before the earlier of the end of the 10 year period or the donor's death. As a substantive matter, the 10 year requirement may cause some donors not to make gifts, depriving charitable institutions and therefore the public of the opportunity to use and enjoy works of art and other property. We suggest amending the provisions to require that either a gift or a binding pledge be made within the required time period.

Under the new PPA provisions, the consequences for missing the deadline are severe. The full income and gift tax charitable deduction claimed for the initial fractional contribution is recaptured with interest and the resulting income tax is increased by a 10% penalty. We believe that the time when interest starts to run should be clarified. In our view, interest should not start to run until the event that triggers the recapture. Otherwise, the results can, at least in certain circumstances, seem unduly harsh. A gift made the day before the expiration of the 10 year period does not result in any recapture of the initial deduction, but a gift made the day after the expiration of the 10 year period results not only in recapture of the initial deduction but also a charge of 10 years of interest on the amount of the deduction – even though the charity ends up receiving 100% interest in the property. We comment on the gift tax recapture rules in general in paragraph E below.

D. Substantial Physical Possession and Related Use Requirements. I.R.C. Secs. 170(o)(3)(A)(ii) and 2522(e)(3)(A)(ii), added by the PPA, require a charity to have “substantial physical possession of the property” and to have “used the property in a use which is related to [its] purpose or function” for 10 years after the initial fractional contribution or the donor’s death, if earlier. If either of these requirements is not met, the same recapture rule described above applies. It would be helpful to clarify the meaning of “substantial physical possession,” particularly in light of the severe consequences of noncompliance. In addition, we suggest that there be exceptions, for example, if a painting has deteriorated and would be damaged by transporting it between the donor and the donee, or if the museum temporarily does not have exhibit space for the painting. Again, we suggest that interest should run only from the time of failure to meet the substantial use requirement, not from the time of the original gift.

We question why the new related use rules for fractional contributions are more rigid and punitive than the new related use rules, also imposed by the PPA, for gifts of a donor’s entire interest in tangible personal property. The new rules in I.R.C. Sec. 170(e)(7) provide that if a donee disposes of donated tangible personal property within three years of the date of the donation, the donor must recapture the difference between the amount of the income tax deduction taken by the donor and the donor’s cost basis in the property, unless the donee certifies that the use of the property by the donee was related to the donee’s charitable purpose or that the intended use of the property has become impossible or infeasible. I.R.C. Sec. 170(e)(7)(D). The result of the different related use rules is that if a donor makes a fractional contribution and two years later the donee disposes of the property, the donor is subjected to a full recapture of the income and gift tax deduction, plus penalty and interest, while the donor of a 100% interest in the same situation must only recapture the amount of the deduction above cost basis but only if the donee does not certify to the related use or impossibility of use.

If Congress wishes to reconcile the related use requirements applicable to full gifts of tangible personal property and fractional contributions, the amount subject to recapture for income tax purposes under I.R.C. Sec. 170(o) could be limited to the difference between fair market value and cost basis at the time of the gift without interest or penalties. If the interest charge is retained for recapture due to change in use of fractional contributions, we recommend clarifying that interest runs only from the time of the change in use.

E. Gift Tax Recapture. We suggest that the new recapture rules for fractional contributions not be applied for gift tax purposes. We are concerned that the gift tax recapture rules inappropriately penalize a donor for making a gift to charity. Unlike the recapture of an income tax deduction which simply restores taxable income to the donor, the recapture of the gift tax results in an out of pocket cost on a transfer to charity. This harsh result is at variance with the gift tax regime, which does not otherwise impose gift tax on charitable transfers.

F. Narrow Ownership Requirements. New I.R.C. Secs. 170(o)(1)(A) and 2522(e)(1)(A) generally deny income and gift tax deductions for fractional contributions unless all interests in the property are held by the donor or the donor and the donee immediately before the contribution. This requirement may prohibit any fractional gift of community property. We recommend clarifying the application of this provision to gifts of community property. We also recommend, as allowed by new I.R.C. Secs. 170(o)(1)(B) and 2522(e)(1)(B), that the Secretary of the Treasury adopt regulations that provide an exception to the new ownership requirements where all persons who hold an interest in the property make proportional fractional contributions.

IV. SUPPORTING ORGANIZATIONS

A. General Observations. Prior law provided Treasury the means to combat the abuses intended to be addressed by the PPA with regard to SOs. The new legal regime results in severe restrictions on a charity’s access to working capital and sources of funding through the imposition of penalties and sanctions on private

foundations, SOs, and supported organizations. The following comments focus on four key provisions of the PPA.

B. Contributions to Supporting Organizations.

1. Prohibited Contributors. Section 1241(b) of the PPA places substantial limitations on receipt of funds by Type I and Type III SOs from “prohibited contributors” (i.e., individuals or entities who alone or with other specified persons maintain direct or indirect control over an SO’s supported organization). Contributions from such contributors will result in immediate disqualification of the SO’s tax-exempt status and its reclassification as a private foundation.

This limitation negatively impacts the tax-exempt community because it arbitrarily prohibits donors and charities from using SOs in traditional planning situations. For example, donors and charities use SOs for creditor protection purposes, particularly Type III SOs, the assets of which are considered separate and apart from those of its supported organization(s) for legal and creditor purposes. Maintaining the integrity of gifts separate and apart from the general assets and liabilities of charities that have higher risk profiles, such as hospitals, universities, churches, or other service-based organizations, continues to be a fundamental goal in providing for the longevity of such organizations.

Congress should consider instead addressing this issue through disclosure of the relationship between the donor and the supported organization by the SO and a demonstration on the part of the SO that it is in fact distributing its funds to or for the benefit of the specific supported organization to meet the SO’s attentiveness requirements. This can be done through disclosure on the SO’s Federal Form 990. Further, Treasury has a means to police this issue via the attentiveness test provisions of I.R.C. Sec. 509(a)(3) and the Treasury Regulations thereunder.

2. Private Foundations. Under Section 1244 of the PPA, private foundations are penalized for certain contributions made to Type III SOs and, in certain circumstances, to Type I and Type II SOs, due to the fact that such grants no longer qualify toward a private foundation’s minimum distribution requirements under I.R.C. Sec. 4942. Such grants will not qualify if made to (a) non-functionally integrated Type III SOs or (b) Type I, Type II or functionally integrated Type III SOs if (i) a disqualified person of the private foundation directly or indirectly controls the SO or a supported organization of the SO, or (ii) such grant is a distribution determined by regulation to be “inappropriate.” Additionally, Section 1244(b) of the PPA imposes expenditure responsibility requirements on any private foundation that makes a grant to any of the above-referenced SOs. As a result, SOs and the charities they support will likely see funds from private foundations substantially reduced, since the “cost” of such a private foundation’s grant is increased by its not counting toward the private foundation’s minimum distribution requirements under I.R.C. Sec. 4942 and because such grants will be subject to expenditure responsibility. Further, private foundations may be reluctant to make grants to SOs until Treasury issues regulations clarifying what distributions are “inappropriate.” Instead of penalizing private foundations, Congress should consider addressing this issue by revising the minimum distribution requirements for SOs to provide that in a year in which an SO receives a grant from a private foundation, a portion of that grant should be included as part of the base amount against which the SO’s minimum distribution requirement is calculated.

C. Excess Business Holdings. Section 1243(a) of the PPA amends the excess business holdings rules under I.R.C. Sec. 4943 by adding a new subparagraph (f), which requires certain SOs which receive gifts of closely held business interests to comply with the excess business holdings rules normally applicable to private foundations, unless Treasury has provided an exemption to an SO with business holdings on the basis that such business holdings are consistent with the SO’s exempt purposes. Non-functionally integrated Type III SOs and Type II SOs that receive contributions from persons or entities which maintain direct or indirect control over one or more of the SO’s supported organizations are subject to this new regime; Type I SOs are

not. Further, under this regime, a 2% de minimis holdings threshold is allowed as a statutory safe harbor before the excess business holdings rules would be triggered.

Under the PPA, private business owners have lost an important way to protect the family business from a forced sale on the owner's death. Additionally, business owners are no longer able to use their closely held business interests as a means to fund their lifetime charitable goals. Further, taxpayers cannot reasonably proceed with charitable gifts with the hope that Treasury will provide an exemption based on a determination that the SO's ownership of the business interest is consistent with the SO's tax-exempt purpose, as there is insufficient guidance as to what Treasury would consider to be "consistent" in this context to warrant an exemption being granted.

We suggest that Congress consider instead using the existing attentiveness test and control test regulations to address this problem. Under such tests, Treasury can assess whether an SO is attentive to its supported organizations or subject to the indirect control of the donor. If Treasury concludes that the SO is not attentive or is subject to too much donor control, Treasury can reclassify the SO as a private foundation. As reclassified, the SO would be subject to the excess business holdings provisions of Chapter 42. Lapham v. Commissioner, T.C. Memo 2002-293, is a clear example of Treasury using these rules effectively to combat an abusive situation. Thus, Treasury could continue to use prior law to address the problem. It could also require gifts of business interests to be more fully disclosed in the first and subsequent years, and then analyze such gifts on an ongoing basis under the "attentiveness test."

D. Excess Benefit Transactions. Section 1242 of the PPA provided for sweeping reforms to all three types of SOs with regard to any direct or indirect compensation or other arrangement which violates the excess benefit transaction rules of I.R.C. Sec. 4958. Thus, under new I.R.C. Sec. 4958(c)(3), any loan, grant, compensation, financial arrangement, or other similar payment between an SO and a "specified person" or any loan to a disqualified person will be deemed an excess benefit transaction and subject to the sanctions provided under I.R.C. Sec. 4958. A specified person includes substantial contributors (individuals who have donated more than \$5,000 to the SO if the amount is more than 2% of the bequests received by the SO through the close of the taxable year), a member of such person's family, or a 35% controlled entity.

Compensatory arrangements in the non-profit sector must be "reasonable" in order to be respected under state and federal law. Indeed, even the strict self-dealing rules applicable to private foundations exempt payment of reasonable compensation to disqualified persons. I.R.C. Sec. 4941(d)(2)(E). A strict ban on compensating individuals performing services in official capacities for SOs appears to be an unreasonable departure from normal industry compensation standards of the non-profit sector, and the breadth of the provision may cause unintended results. For example, an employee of a tax-exempt organization who is also a director of an SO that supports such tax-exempt organization would technically be considered a disqualified person to both organizations, requiring the supported organization to carry out burdensome compliance and reporting to avoid the imposition of the excess benefit transaction penalties. While combating abusive transactions in which SOs make loans, grants, or other financial arrangements with "insiders" is appropriate, prohibiting even reasonable compensation for officers, directors, or employees of SOs, regardless of their status, we believe is inappropriate.

E. Minimum Distribution Requirements. Section 1241(d) of the PPA requires Treasury to promulgate regulations modifying the distribution requirements for non-functionally integrated Type III SOs. Currently, non-functionally integrated Type III SOs are required to distribute "substantially all" of their net income each year, which typically has meant a distribution of 85% of an SO's net income. Under the regulations, Treasury is to establish a distribution regime under which SOs would be required to make a distribution of a percentage of their income or assets, so long as such distribution constitutes a "significant amount."

The current law already requires non-functionally integrated SOs to distribute substantially all of their net income each year to one or more of each such SO's supported organizations. Therefore, a minimum distribution requirement currently exists. The current methodology also ensures that the SO's distribution pattern clearly reflects the market conditions in which the SO is operating. Consequently, donors and charities can manage and maintain budgets and ensure that spending patterns are in line with the current and future support expected from the SO.

In addition, there is no guarantee that requiring a distribution standard based on a percentage of assets, like the requirement imposed on private foundations, would result in greater distributions to supported organizations and increased attentiveness. For example, an SO which holds a closely held business interest worth \$1,000,000 that generates \$200,000 in income would, under the current test, be required to distribute \$175,000 (i.e., 85% of \$200,000), versus \$50,000 under the 5% of assets test. We suggest that Congress consider using prior laws (i.e., the attentiveness test) to address this issue. An increase in attentiveness test audits would provide a significant deterrent to the manipulation of income and cash flow distributions from SOs. It would also present the opportunity for Treasury to analyze the nature of the relationships between the various asset holdings of the SO in light of the Lapham decision (discussed above) to determine if the SO's public charity status should be revoked and the entity reclassified as a private foundation, triggering application of all of the excise tax provisions applicable to private foundations.

The PPA provisions impose substantial excise taxes and penalties to address perceived abuses involving SOs. However, Treasury already had the statutory means to address the problems intended to be corrected by these new laws, and in fact did so with success when the circumstances warranted action. The new legal regime results in unintended negative consequences on the non-profit community by restricting access to working capital, decreasing sources of funding, and penalizing private foundations, SOs, and supported organizations with automatic sanctions, potential reclassification of tax-exempt status, and increased compliance requirements.

CONCLUSION

We welcome the review by the Subcommittee on Oversight of the impact on charities of the significant changes made by the PPA. We appreciate your consideration of our comments.

CHI99 4851219-8.T08612.0011