CLIENT ALERT

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Charitable Provisions of H.R. 4 Pension Protection Act of 2006

On August 17, 2006, President Bush signed the Pension Protection Act of 2006 (the "Act"), H.R. 4.[1] Although the aptly named legislation largely relates to pension plans, also included in the Act are significant revisions to the provisions of the Internal Revenue Code relating to charitable contributions, private foundations, donor-advised funds, and supporting organizations. This newsletter is intended to provide you with a brief overview of certain significant charitable provisions of the Act.

1. IRA Charitable Rollover

Individuals who have reached age 70½ may exclude from income up to $100,000 per year in retirement plan assets if such assets are contributed to a qualified charity from an IRA. The exclusion applies only if the entire distribution would otherwise qualify for the charitable deduction. Private foundations, donor-advised funds, charitable split interest trusts, and supporting organizations are not qualified charities for this purpose; all remaining public charities are qualified charities. The exclusion is available for charitable contributions made in 2006 and 2007.

2. Clothing, Household Items, and Charitable Contributions

The Act limits the charitable deduction for contributions of clothing and household items. No charitable deduction is allowed unless the clothing or household item is in good used condition or better. Further, the Act authorizes the Secretary of the Treasury to issue Treasury Regulations denying a charitable deduction for contributions of clothing or household items that have a minimal monetary value. Notwithstanding the foregoing limitations, if a qualified appraisal is provided for a charitable contribution of more than $500, the deduction will be allowed. This provision applies to all contributions made after the date of enactment of the Act.

[1] This analysis is based on the provisions of H.R. 4 as passed by the Senate on August 3, 2006

3. Recapture of Charitable Deduction and Contributions of Tangible Personal Property

Generally, if a donor makes a contribution of tangible personal property to an eligible charity, the donor's deduction is limited to the donor's basis in the property unless the tangible personal property is used for the charity's exempt purpose. For example, a donor would receive a charitable deduction equal to fair market value for donating a painting to a museum, but would receive a charitable deduction limited to the donor's basis if the same painting were contributed to a community food drive.

The Act further limits this deduction. If a fair market value charitable deduction is claimed for a contribution of tangible personal property to an eligible charity, and the donee charity sells the property within three years of such contribution, the donor's charitable deduction either will be limited to basis or subject to recapture, depending on the date of disposition. Specifically, if the property is sold in the same year as the contribution, the donor's deduction will be limited to basis. If the property is sold after the year of the contribution, but before a three-year period has expired, the donor must report as ordinary income in the year of such disposition the amount by which the claimed fair market value exceeded the donor's basis. This result can be avoided in certain limited circumstances if the donee charity makes a certification to the Internal Revenue Service. This provision applies to all contributions made after September 1, 2006.

4. Contributions of Fractional Interests in Tangible Personal Property

The Act places restrictions on the allowance of the charitable deduction for contributions of fractional interests in tangible personal property. The Act also places limitations on the valuation of the charitable deduction for such fractional interests and provides for recapture of the charitable deduction under certain circumstances. This provision applies to all contributions made after the date of enactment of the Act.

5. Record Retention for Cash Gifts

Record-keeping requirements for charitable contributions of cash have been revised. For contributions of cash, a bank receipt or a written receipt from the donee charity is required. As always, if the value of the gift is $250 or greater, additional substantiation requirements are imposed by the Internal Revenue Code. This provision applies to all contributions made in taxable years following the date of enactment of the Act.

6. Overvaluation Penalties

Taxpayers must be more careful than ever when reporting the value of their charitable contributions. The Act lowers the threshold for imposing income tax accuracy-related penalties on a taxpayer and provides that a substantial valuation misstatement exists when the claimed value of the property is 150% or more of the correct value (previously 200%). A gross valuation misstatement exists when the claimed value of the property is 200% or more of the correct value (previously 400%). The Act also lowers the threshold for accuracy-related penalties for estate and gift taxes. These new rules apply to all returns filed after the date of enactment of the Act. Finally, the Act also defines the term "qualified appraiser" and penalizes appraisers that prepare appraisals resulting in substantial or gross valuation misstatements.

7. Public Disclosure of Form 990-T

Tax-exempt organizations must allow public inspection of their annual returns. Prior to the Act, this disclosure obligation did not mandate public inspection of Form 990-T, the form on which tax-exempt organizations report unrelated business income tax. The Act now requires that Form 990-T be made available for public inspection, and it is effective for all returns filed after the date of enactment of the Act.

8. Annual Filings for Organizations with Gross Receipts of Less than $25,000

Generally, all tax-exempt organization must file annual informational returns. One exception to this general rule is that organizations that normally have no more than $25,000 of annual gross receipts need not file an informational return. The Act now requires that such organizations provide prescribed electronic notice to the Internal Revenue Service. This provision is effective with respect to all annual periods beginning after 2006.

9. Increase in Penalty Excise Taxes

The Act increases penalty excise taxes with respect to the following provisions applicable to private foundations:

a. With respect to the penalty excise tax on acts of self-dealing as provided in Internal Revenue Code Section 4941:

   - The initial tax on the self-dealer has been increased from 5% of the amount involved to 10% of the amount involved.
   - The initial tax on foundation managers has been increased from 2.5% of the amount involved to 5% of the amount involved.
   - The maximum initial tax and maximum additional tax on foundation managers may not exceed $20,000 per act (previously $10,000 per act).

b. With respect to the penalty excise tax on the failure to distribute income as provided in Internal Revenue Code Section 4942, the initial tax on the foundation has been increased from 15% of the undistributed amount to 30% of the undistributed amount.

c. With respect to the penalty excise tax on excess business holdings by private foundations as provided in Internal Revenue Code Section 4943, the initial tax on the foundation has been increased from 5% of the value of such holdings to 10% of the value of such holdings.

d. With respect to the penalty excise tax on jeopardy investments as provided in Internal Revenue Code Section 4944:

   - The initial tax on the foundation has been increased from 5% of the amount so invested to 10% of the amount so invested.
   - The initial tax on foundation managers has been increased from 5% of the amount so invested to 10% of the amount so invested.
   - The maximum initial tax on foundation managers may not exceed $10,000 per investment (previously $5,000 per investment), and the maximum additional tax on foundation managers may not exceed $20,000 per investment (previously $10,000 per investment).

e. With respect to the penalty excise tax on taxable expenditures of a private foundation as provided in Internal Revenue Code Section 4945:

   - The initial tax on the foundation has been increased from 10% of the amount of the expenditure to 20% of the amount of the expenditure.
   - The initial tax on foundation managers has been increased from 2.5% of the amount of the expenditure to 5% of the amount of the expenditure.

- The maximum initial tax on foundation managers may not exceed $10,000 per expenditure (previously $5,000 per expenditure), and the maximum additional tax on foundation managers may not exceed $20,000 per expenditure (previously $10,000 per expenditure).

Although many of the tax rates for initial taxes and the ceilings for taxes imposed on self-dealers, foundation managers, and foundations with respect to both initial taxes and additional taxes have been increased, none of the provisions of the Act increase the tax rates for “additional taxes” imposed under Internal Revenue Code Sections 4941 through 4945 with respect to private foundations when there is a failure to correct the improper act.

Finally, the dollar limitation on the tax imposed on organization managers of public charities and social welfare organizations relating to excess benefit transactions has been increased from a maximum of $10,000 to a maximum of $20,000 per transaction.

These provisions apply to all taxable years beginning after the date of enactment of the Act.

10. Increased Tax Base for Excise Taxes on Private Foundations

Pursuant to Internal Revenue Code Section 4940, private foundations are subject to an annual excise tax of 2% on net investment income, reduced to 1% in certain circumstances. The Act expands the base of net investment income that will be subject to this excise tax, and specifically includes realized capital gains. Further, the Act authorizes the Treasury Department to issue Treasury Regulations excluding certain exempt-use property involved in like-kind (“Starker”) exchanges from the excise tax. This provision is effective for all taxable years beginning after the date of enactment of the Act.

11. Donor-Advised Funds – Definition and Treasury Study

Prior to the Act, the Internal Revenue Code did not define the term “donor-advised fund” or distinguish donor-advised funds from other types of public charities. The Act now provides a definition of a donor-advised fund. Further, the Act instructs the Internal Revenue Service to conduct a one-year study on the organization and operation of donor-advised funds. It is anticipated that Congress could enact sweeping changes to the law governing donor-advised funds after the completion of this study.

12. New Rules Applicable to Donor-Advised Funds.

Several new rules have been imposed with respect to donor-advised funds, many of which are briefly described below. Subject to a few exceptions, most of these rules are effective either immediately after the date of enactment of the Act or for taxable years beginning after the date of enactment of the Act.

a. Distributions from Funds. Limitations have been imposed with respect to the permissible beneficiaries of distributions from donor-advised funds.

b. Prohibited Benefits. Substantial penalties will be imposed if the donor, an advisor, or a related party of a donor or advisor receives more than incidental benefits. As a result of this provision, donors should be particularly careful when tickets, prizes, or other benefits are received as a result of a charitable distribution from a donor-advised fund.

c. Scope of Excess Benefit Rules. The prohibition on excess benefits set forth under Internal Revenue Code Section 4958 has been substantially broadened with respect to donor-advised funds.

d. Application of Excess Business Holdings Rules. Internal Revenue Code 4943 provides that the combined holdings of a private foundation and certain disqualified persons cannot exceed 20% of the voting stock of a corporation (or the equivalent ownership of a partnership or other entity), subject

to certain limited exceptions. The prohibition has now been expanded to apply to donor-advised funds. This rule applies to taxable years beginning after the date of the Act; however, more lenient transition rules are provided for "grandfathered" stock holdings.

e. No Mandatory Payout. The final version of the legislation deleted any requirement that a donor-advised fund must distribute a certain percentage of its assets annually. Although neither current law nor the Act require mandatory payouts, the charitable organization that operates the fund may impose such requirements.

13. Qualification of Type III Supporting Organizations

The Internal Revenue Code provides for three types of supporting organizations, commonly referred to as Type I, Type II, and Type III supporting organizations. To qualify as a Type III supporting organization, the organization must meet two subtests: (i) the responsiveness test, and (ii) the integral part test. Prior to the Act, the responsiveness test could be satisfied in one of two ways: by showing that the supporting organization is a charitable trust subject to certain requirements, or, alternately, by showing both that (i) the governing bodies of the supporting organization and the supported organization have certain shared members or a close and continuous relationship, and (ii) the supported organization has a significant voice in the supporting organization. The Act eliminates the former charitable trust test, making compliance with the latter test mandatory for Type III supporting organizations. This requirement will be effective one year after the date of enactment of the Act.

14. New Rules Applicable to Supporting Organizations

The Act imposes additional restrictions and limitations on supporting organizations. Whereas some of the provisions apply to all types of supporting organizations, other provisions apply to only certain types of supporting organizations. Subject to the specific exceptions noted below, most of these rules are either effective immediately after the date of enactment of the Act or effective for taxable years beginning after the date of enactment of the Act. Several of the new provisions relating to supporting organizations are briefly described below. Notably, certain portions of the prescribed Treasury study on donor-advised funds are also intended to address supporting organizations. Therefore, further legislation on supporting organizations may result.

a. Reporting Requirements. The Act requires a Type III supporting organization to provide information to its supported organizations annually.

b. Prohibited Benefits. An organization will not qualify as a Type I or Type III supporting organization if it receives a gift from anyone who directly or indirectly controls a supported organization.

c. Scope of Excess Benefit Rules. The prohibition on excess benefits set forth under Internal Revenue Code 4958 has been substantially broadened with respect to all types of supporting organizations.

d. Application of Excess Business Holdings Rules. Internal Revenue Code 4943 provides that the combined holdings of a private foundation and certain disqualified persons cannot exceed 20% of the voting stock of a corporation (or the equivalent ownership of a partnership or other entity), subject to certain exceptions. The prohibition has now been expanded to apply to most Type III supporting organizations and certain Type II supporting organizations. This rule applies to taxable years beginning after the date of the Act; however, more lenient transition rules are provided for "grandfathered" stock holdings.

e. Grants by Private Foundations to Supporting Organizations. A grant from a private, nonoperating foundation will not be a qualifying distribution if it is made to most Type III supporting organizations as well as to Type I and Type II supporting organizations if a disqualified person of a private foundation directly or indirectly controls a supported organization. Because the IRS's Publication 78 does not disclose the basis for an organization's public charity status classification, grant-making or foundations will need to inquire about this issue before making a grant.

f. Foreign Supported Charities. Type III supporting organizations may not support foreign charities. This provision is not effective until the third taxable year of the supporting organization beginning after the date of enactment of the Act.

g. Mandatory Payout. The Act directs the Secretary of the Treasury to promulgate new Treasury Regulations requiring most Type III supporting organizations to make mandatory annual distributions.

Extension of Qualified Tuition Programs

Section 529 of the Internal Revenue Code provides that certain contributions to qualified tuition accounts (commonly referred to as "529 plans") qualify for the gift tax annual exclusion (currently $12,000 per donor per donee) and corresponding annual exclusion from generation-skipping transfer tax. Further, a donor may contribute in a single year up to five times the annual gift tax exclusion and treat such contribution as having been made over the five year period. Further, the qualified tuition program is exempt from income tax so the assets in the account grow tax-free. These provisions were initially scheduled to expire in 2010 based on the "sunset" provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"). The Pension Protection Act of 2006, H.R. 4, now repeals the sunset provision of EGTRRA with respect to such 529 plans so that distributions from such plans will continue to be tax-free for qualified higher education expenses.

If you have any questions regarding the Act, we would be happy to assist you. Please contact Leah Bishop (lbishop@loeb.com) at 310.246.2353 or Eliot P. Green (egreen@loeb.com), at 212.407.4908.

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