Charitable Giving Incentives and Reforms
Under the Pension Protection Act of 2006
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Charitable Giving Incentives and Reforms
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I. Overview

Following several years of debate and discussion, and a multitude of hearings and unpassed bills, a package of charitable giving incentives and reforms has now been passed by Congress and signed into law by the President on August 17, 2006 as part of the Pension Protection Act of 2006, H.R. 4 (hereinafter the “Act”). The Act makes the most significant changes to the rules governing charitable contributions and charitable entities since the Tax Reform Act of 1969. While its charitable giving incentives are rather modest, the Act places significant limitations on the deductibility of a host of charitable contributions that have been of particular concern to Congress in recent years, increases existing taxpayer penalties for the overvaluation of property contributed to charity and subjects appraisers who overvalue contributed property to new penalty provisions. The Act also makes sweeping changes to the rules applicable to donor advised funds and supporting organizations, increasingly popular philanthropic entities that have come under intense scrutiny by both Congress and the IRS in recent years in light of various abuses that have occurred in this area. A particular favorable note in this area, however, is that the Act does not impose minimum annual distribution requirements on donor advised funds or their sponsoring organizations, as was required under prior bills, and does not eliminate Type III supporting organizations or modify the payout requirement for such organizations, as had previously been proposed. Also impacted under the Act are private foundations, as the existing excise taxes imposed under Chapter 42 of the Internal Revenue Code have generally been doubled, the net
investment excise tax base has been expanded, and distributions by private foundations to certain supporting organizations are now subject to less favorable treatment and additional substantiation requirements. While the charitable giving incentives are only temporary measures, extending only through December 31, 2007, the charitable reform provisions are permanent, with such provisions in certain cases having retroactive effect prior to the August 17, 2006 enactment of the Act. This article explores the provisions of the Act that are most relevant to donors, including the effect of the new law on donor advised funds, supporting organizations, and private foundations.

II. Charitable Giving Incentives Under the Act

Although it contains only a few charitable giving incentives, generally affecting only a limited number of taxpayers under limited circumstances, the Act should have a major impact on charitable giving because of its long-awaited and much-heralded “IRA charitable rollover provision,” which allows donors to make tax-free distributions to charity from an individual retirement account (“IRA”). This provision has long been sought by the charitable sector and is anticipated to substantially increase annual charitable giving. The IRA charitable rollover provision under the Act is itself rather limited, however, as transfers to private nonoperating foundations, donor advised funds and all supporting organizations and, contrary to certain prior bills, split-interest entities, do not qualify for tax-free rollover treatment. Only people who are 70 1/2 or older may take advantage of the rollover provision and the rollover treatment is capped at $100,000 per year. Therefore, the rollover provision can neither be used by younger people nor to fund major charitable endowments. Moreover, like all other charitable giving incentives under the Act, the IRA charitable rollover provision is only a temporary measure, set to expire on December 31, 2007. The Act also does not contain several charitable giving incentives that
have been included in prior bills and, like the IRA charitable rollover, have been long-sought by the charitable sector. Most notably, the Act does not include a “non-itemizer” deduction allowing taxpayers who do not itemize their deductions to deduct charitable contributions, an even higher profile charitable giving incentive than the IRA charitable rollover given its potential effect on two-thirds of the individual taxpayers in the country. The following provides a detailed analysis of the IRA charitable rollover provision, as well as the other principal charitable giving incentives under the Act.

A. IRA Charitable Rollover Provision

Funding lifetime charitable giving from IRA assets has traditionally been a bad choice for donors because the amount of gross income attributable to a withdrawal from an IRA may not be fully offset by the available charitable contribution deduction, thereby resulting in a taxable event notwithstanding that the entire amount of the withdrawal is contributed to charity. For example, where a donor withdraws $100,000 from an IRA that is included in gross income and contributes the same $100,000 to charity, the $100,000 charitable contribution deduction will not necessarily fully shelter the $100,000 of gross income, in which case the contribution funded by the IRA withdrawal would create an additional income tax burden on the donor. The culprit, of course, is IRC § 170(b), which limits the amount of the charitable contribution deduction in any taxable year to a maximum of 50% of the donor’s gross income. Thus, unless the donor in the above situation has at least $100,000 of additional income, bringing the total gross income to $200,000 or more, the 50% gross income limitation will prevent a charitable contribution deduction for the entire $100,000 in the same taxable year in which the $100,000 of income is recognized. Even if the amount of the donor’s gross income is sufficient to avoid the 50% limitation under IRC § 170(b) with respect to charitable contributions funded by an IRA, other
charitable contributions funded with other assets of the donor may then become subject to such limitation. Moreover, to the extent an IRA withdrawal is included in a donor’s gross income, other limitations placed on itemized deductions based on a percentage of gross income are increased, thereby further reducing the amount of the itemized deductions, including charitable contributions, that may otherwise be deductible by the donor. Thus, even where the gross income limitation under IRC § 170(b) does not limit the available charitable deduction, other limitations on deductibility based on gross income reduce the amount of the deduction otherwise available for charitable and other itemized deductions. Other course, where a donor does not itemize deductions, no charitable deduction is available, in which case no deduction is available to offset the gross income inclusion attributable to an IRA withdrawal used to fund a charitable contribution. The inclusion of an IRA withdrawal in gross income may also have other negative tax implications. For example, the amount of social security benefits subject to income tax and the available alternative minimum tax exemption are dependent on the amount of a taxpayer’s income where the greater the gross income, the less favorable the tax treatment. Finally, donors in states that tax IRA withdrawals but do not provide for charitable deductions face a state income tax burden where IRA assets fund a charitable contribution.

The IRA charitable rollover provision brought about by the Act, contained in new IRC § 408(d)(8) (“Distribution for Charitable Purposes”), provides an annual exclusion from gross income up to $100,000 for “qualified charitable distributions” from an IRA, thereby removing the multitude of potential negative tax drawbacks traditionally associated with funding charitable contributions with IRA withdrawals. Thus, individuals otherwise qualifying for IRA charitable rollover treatment desiring to make distributions from an IRA to charity can now do so, to the extent of $100,000 per year and through December 31, 2007, without the risk of any additional
tax burden. Of course, because it is excluded from gross income, a qualified charitable
distribution from an IRA does not qualify for a charitable income tax deduction; otherwise, there
would be the double benefit of income exclusion and a charitable contribution deduction. As
confirmed by the JCT Technical Explanation, a qualified charitable distributions is taken into
account for purposes of the annual minimum required distribution requirement to the same extent
the distribution would have been taken into account under such rules had the distribution been
made to the account holder. As a result, a donor can distribute his entire annual minimum
required distribution to charity without any of such amount being subject to tax. Where a
distribution to charity does not qualify as a qualified charitable distribution, however, the amount
distributed is taxed as if it were received by the account holder and then contributed to the
charity under rules that apply in such a case without regard to the new IRA charitable rollover
provision.

There is nothing under the IRA charitable rollover provision that requires the
administrator of an IRA to make distributions to charity at the direction of the account owner or
to ensure that such distributions qualify as “qualified charitable distributions.” Given that the
IRA charitable rollover provision, like all other charitable giving incentives under the Act, is
only a temporary measure, expiring on December 31, 2007, IRA administrators may be reluctant
to adopt of program of making direct distributions to charity if they determine that significant
expense and administrative burdens must be incurred to institute such program. Where such a
program is adopted, however, IRA administrators should protect themselves against liability in
the event a distribution does not qualify as a “qualified charitable distribution.” In this regard, it
should be noted that the IRA administrator is not in the same shoes as a charity sponsoring a
donor advised fund program, as such a charity, as an IRC § 501(c)(3) tax-exempt entity, has its
own independent obligations under the tax laws to ensure that distributions “recommended” by an advisor to the fund are made to eligible charitable recipients consistent with the exempt purposes of the sponsoring organization. In the case of a distribution from an IRA account that does not, for whatever reason, constitute a qualified charitable distribution, because it is made at the direction of the account owner, the distribution should presumably otherwise be perfectly permissible notwithstanding its ineligibility for charitable rollover treatment. An IRA administrator should consider affirmatively placing the burden on the account owner to ensure compliance with the IRA charitable rollover provisions, so as to remove any doubt regarding the administrator’s responsibility.\textsuperscript{26}

\textit{Statutory Requirements for a Qualified Charitable Distribution from an IRA}

There are six requirements for an IRA distribution to qualify as a qualified charitable distribution under the IRA charitable rollover provision, as set forth below.\textsuperscript{27}

1. \textit{IRA Accounts Only}

The distribution must be made from an IRA. For this purpose, Simplified Employee Plans (“SEPS”) and Savings Incentive Match Plans for Employees (“SIMPLE plans), which are basically IRAs that receive employer contributions, as well as IRC §§ 403(b) and 401(k) plans, profit sharing plans and pension plans, do not qualify under the IRA charitable rollover provision. Many individuals over 70 1/2 years old have large IRA balances attributable to rollovers from retirement accounts maintained at their former employers, which can be used to make distributions to charity. Where applicable, individuals over 70 1/2 years old who do not have IRAs can take advantage of the new IRA charitable rollover provision by, for example, transferring funds from an existing IRC § 401(k) plan into a newly established IRA.
2. **Eligible Recipients: Private Foundations, Donor Advised Funds, Supporting Organizations and Split-Interest Entities Excluded**

The recipient organization must be described in IRC § 170(b)(1)(A), which generally includes organizations commonly referred to as “public charities,” such as churches, hospitals, museums, and educational organizations. Donor advised funds operated by public charities and supporting organizations, while described in IRC § 170(b)(1)(A), are specifically excluded as eligible recipients of IRA charitable rollover distributions, such that distributions to such entities, including, for example, a donor advised fund sponsored by a community foundation or a hospital foundation formed as a supporting organization, do not constitute qualified charitable distributions. Also excluded are split-interest trusts, such as charitable remainder and lead trusts, and private nonoperating foundations, as such entities are not described in IRC § 170(b)(1)(A). Should they seek to be eligible recipients of IRA charitable rollovers, organizations that are currently treated as supporting organizations under IRC § 509(a)(3) that may qualify for public charity status under another provision of the Internal Revenue Code should seek reclassification of their public charity status. This may be the case, for example, for a hospital foundation that initially sought public charity status as a supporting organization which, because of its public support, could otherwise qualify as a public charity under IRC § 509(a)(1) as an organization described in IRC § 170(b)(1)(A)(vi).

3. **IRA Account Owner Must be at Least Age 70 1/2**

The distribution must be made on or after the date that the IRA account holder attains age 70 1/2. Note that distributions do not qualify if made within the taxable year the IRA account holder turns 70 1/2, as distributions only qualify if the individual “has attained age 70 1/2.”
4. **Distributions Must Be Made Directly to Charity**

The distribution from the IRA to the charity must be made “directly by the trustee,” such that the distribution must be made payable directly from the IRA account to the charity. If a check is made payable to the IRA account owner and then endorsed over to the charity, it will not qualify.\(^\text{29}\)

5. **The Distribution to Charity Must Otherwise be Fully Deductible as Charitable Contributions**

A distribution to a charity will only qualify as a qualified charitable distribution if the “entire distribution would be allowable under section 170” as a charitable deduction. Thus, any quid pro quo benefit received by the account holder in return for the distribution, such as the fair market value of a dinner or other benefit that is not disregarded under IRC § 170,\(^\text{30}\) disqualifies the entire distribution, not just the benefit portion, from IRA charitable rollover treatment. The requirement that the entire distribution be allowable as a charitable deduction also prevents the funding of a pooled income fund or a charitable gift annuity from an IRA account from being considered a qualified charitable distribution, notwithstanding that the charity receiving the distribution is a public charity under IRC § 170(b)(1)(A). Further, under IRC § 170(f)(8), no charitable deduction is allowed for any contribution of $250 or more unless the donor obtains a contemporaneous written acknowledgement, which must disclose the value of any goods or services provided by the charity in return for the contribution. Thus, to constitute a qualified charitable distribution, the donor must obtain a written acknowledgement indicating that no goods or services were received in return for the contribution.\(^\text{31}\) When making a distribution from an IRA for which charitable rollover treatment is sought, donors will be best served by first advising the charity that: (1) a distribution will be made from the donor’s IRA account to the charity, which is intended to constitute a “qualified charitable distribution” under IRC § 408(d);
(2) no goods, services or benefits or any kind are to be provided by the charity to the donor or any other party in consideration for the distribution; and (3) upon its receipt of the distribution, the charity must provide an acknowledgement to the donor, acknowledging the amount of the distribution and that no good, services or benefits of any kind were or will be provided to the donor or any other party in consideration for the distribution.

6. **Distribution Must Otherwise Be Included in Gross Income**

A distribution to charity from an IRA will only qualify as a qualified charitable distribution to the extent that the distribution would have otherwise been included in the account owner’s gross income if such distribution had been withdrawn. Thus, only the taxable portion of any IRA distribution can qualify as a qualified charitable distribution. Of course, where a nontaxable distribution is made to a charity from an IRA, the account holder would not only not be subject to tax on the distribution (as such amount is not included in gross income), but would also be entitled to a charitable income tax deduction under IRC § 170(b). This would be the case, for example, for a Roth IRA, where a distribution that would otherwise not be taxable, as is generally the case, is distributed directly to charity. Where, however, a distribution from a Roth IRA would be taxable because it is made within the five-taxable-year period, the distribution can, in such a case, constitute a qualified charitable distribution provided all other requirements for such treatment are met, including the donor attaining age 70 1/2. Under a special and favorable rule under the charitable rollover provision, distributions from an IRA to charity are deemed to come first from the taxable portion of the IRA account, thereby leaving the maximum amount of tax-free dollars behind.
Example

Blake, who is over 70 1/2 years old, has an IRA with a balance of $100,000, consisting solely of deductible contributions and earnings. The entire IRA balance is distributed directly to an organization described in IRC § 170(b)(1)(A) that is not a donor advised fund or a supporting organization, for which Blake receives no benefit in return. But for the new IRA charitable rollover provision, the entire distribution of $100,000 would be includible in Blake’s gross income. Accordingly, under the IRA charitable rollover provision, the entire distribution of $100,000 is a qualified charitable distribution. No amount is included in Blake’s gross income as a result of the distribution and the distribution is not taken into account in determining the amount of Blake’s charitable deduction for the year.

Example

Jeffrey, who is over 70 1/2 years old, has an IRA with a balance of $100,000, consisting of $20,000 of nondeductible contributions and $80,000 of deductible contributions and earnings. In a distribution to an organization described in IRC §170(b)(1)(A) that is not a donor advised fund or supporting organization, $80,000 is directly distributed from the IRA, for which Jeffrey receives no benefit. But for the new IRA charitable rollover provision, a portion of the distribution from the IRA would be treated as a nontaxable return of nondeductible contributions. The nontaxable portion of the distribution would be $16,000, determined by multiplying the amount of the distribution ($80,000) by
the ratio of the nondeductible contributions to the account balance ($20,000/$100,000). Accordingly, under pre-Act law, $64,000 of the distribution ($80,000 minus $16,000) would be includible in Jeffrey’s income. Under the IRA charitable rollover provision, notwithstanding the pre-Act tax treatment of IRA distributions, the distribution is treated as consisting of income first, up to the total amount that would be includible in gross income (but for the IRA charitable rollover provision) if all amounts were distributed from the IRA. The total amount that would be includible in income if all amounts were distributed from the IRA is $80,000. Accordingly, under the IRA charitable rollover provision, the entire $80,000 distributed to the charitable organization is treated as includible in income and is a qualified charitable distribution. No amount is included in Jeffrey’s income as a result of the distribution and the distribution is not taken into account in determining the amount of Jeffrey’s charitable deduction for the year. In addition, the $20,000 of the amount remaining in the IRA is treated as Jeffrey’s nondeductible contributions.

B. Basis Adjustment to Stock of S Corporation Contributing Appreciated Property

In a change benefiting shareholder’s of S corporations, the Act eliminates the disparity in treatment between an S corporation shareholder and a partner in a partnership by limiting the reduction of a S corporation shareholder’s stock basis attributable to a charitable contribution of appreciated property by the S corporation to the shareholder’s allocable share of the basis in the contributed property. If an S corporation or partnership makes a charitable contribution of money or property to a qualified charity, each shareholder and partner takes into account his allocable share of the contribution, as reflected on Schedule K-1, in determining his own
income tax liability. Prior to the Act, where an S corporation made a contribution of appreciated property deducted at fair market value, IRC § 1367(a)(2)(B) required that a shareholder’s basis in his S corporation stock be reduced by the amount of the charitable deduction reflected on the shareholder’s Schedule K-1, which is based on the shareholder’s allocable share of the fair market value of the contributed property. This treatment could subsequently lead to substantial negative tax consequences to the shareholder. For example, where an S corporation makes a charitable contribution of appreciated property for which a fair market value deduction is claimed, the shareholder would be subsequently taxed on the appreciation inherent in the contributed property upon the disposition of the stock (upon liquidation or sale), since the basis in the S corporation stock was required to be reduced by the allocable share of the contribution deduction (based on fair market value), rather than merely the allocable share of the basis of the contributed property. Further, the reduction in the S corporation stock basis by the allocable share of the contribution deduction may prevent the deductibility of future losses passed through to the shareholder, as loss deductions are limited to the basis in the S corporation stock.\(^{35}\) This treatment is contrary to the treatment of partners in a partnership, where the basis of each partner’s interest in the partnership is reduced only by the partner’s share of the basis in the property, without regard to the whether the deduction for the charitable contribution is based on the property’s fair market value.\(^{36}\) Under the Act, IRC § 1367(a)(2)(B) is amended to provide that the amount of a shareholder’s basis reduction in the stock of the S corporation attributable to charitable contributions by the S corporation will be equal to the shareholder’s allocable share of the tax basis of the contributed property, thereby putting an S corporation shareholder on par with a partner of a partnership making a charitable contribution.\(^{37}\)
Example

An S corporation with two individual shareholders makes a charitable deduction of capital gain property having a fair market value of $100,000 and an income tax basis of $25,000. Assuming the fair market value of the property is otherwise deductible under IRC § 170, each shareholder will have a pass through charitable deduction equal to $50,000, but will only reduce the basis of his S corporation stock by $12,500 (assuming that the basis of the S corporation stock is at least $12,500, as the basis of the stock can never be less than $0). Prior to the Act, each shareholder’s basis of his S corporation stock would have been reduced by the entire amount of the $50,000 pass through charitable contribution deduction (assuming the basis of the S corporation stock is at least $50,000).

This change in the law, which applies to contributions made by S corporations in taxable years beginning in 2006 (including before the enactment of the Act) or 2007, has been contained in the number of prior bills. By placing S corporations on parity with partnerships, the Act removes the negative basis implications that have historically applied to contributions of appreciated property by S corporations, which have acted as a deterrent in promoting charitable contributions by S corporations.

C. Increase of Percentage Limitations on Conservation Easements

In order to encourage contributions of real property for conservation purposes, the Act makes several favorable changes to the percentage limitation rules under IRC § 170(b) applicable to “qualified conservation contributions” by individuals. In the case of farmers and ranchers operating as either a sole proprietorship or closely held corporation, even more favorable treatment is available, as it may now be possible for qualified conservation contributions to
shelter all of farmer or rancher’s taxable income. These changes, which apply to contributions made in taxable years beginning in 2006 (including before the enactment of the Act) or 2007, enhance the qualified conservation contribution, particularly with respect to farmers and ranchers who have limited annual incomes but own property having significant conservation value. Although the special treatment accorded qualified conservation contributions is only a temporary measure, whereby contributions made in taxable years beginning after December 31, 2007 do not qualify, any unused deductions attributable to contributions made in taxable years beginning in 2006 or 2007 may be carried over for 15 years and deductions in the carryover period remain eligible for the special treatment provided under the Act.

Qualified Conservation Contributions by Individuals

Prior to the Act, “qualified conservation contributions” by individuals were subject to the same percentage limitation regime under IRC § 170(b) as all other contributions of property. Thus, if the qualified conservation contribution was capital gain property and the deduction was based on fair market value, the percentage limitation rule under IRC § 170(b)(1)(C)(i) was applicable, limiting the amount the deduction to 30% of the donor’s “contribution base.” If it was not capital gain property or the special election under IRC § 170(b)(1)(C)(iii) was made, in which case the deduction was limited to basis, IRC § 170(b)(1)(A) was applicable, limiting the amount of the deduction to 50% of the donor’s contribution base. Under the Act, qualified conservation contributions are subject to their own separate percentage limitation under which such contributions are allowed “to the extent the aggregate of such contributions does not exceed the excess of 50 percent of the taxpayer’s contribution base over the amount of all other charitable contributions.” Thus, the 30% limitation on contributions of capital gain property no longer applies to qualified conservation contributions, as a 50% limitation now applies to such
contributions. Moreover, the new percentage limitation regime applicable to qualified conservation contributions is very favorable with respect to the priority and carryover rules under IRC § 170. Contrary to a contribution subject to the 50% limitation under IRC § 170(b)(1)(A), such as a contribution of cash to a public charity, the deduction for qualified conservation contributions is taken into account after all other charitable contribution deductions that are otherwise allowable. Thus, current year contributions to all other organizations, and presumably any carryover from a prior year, are deducted prior to qualified conservation contributions. This is a particularly favorable ordering regime because any unused deduction attributable to qualified conservation contributions may be carried over for up to 15 taxable years, rather than the 5-year carryover period that applies to all other contributions. Of particular note is that a carryover of a qualified conservation contribution during the 15-year carryover period is subject to the same special treatment in the carryover year, notwithstanding that such treatment does not apply to a current year contribution made after December 31, 2007.

**Example**

An individual with a contribution base of $100,000 makes a qualified conservation contribution of property with a fair market value of $80,000 and makes other charitable contributions subject to the 50% limitation of $60,000. The individual is allowed a deduction of $50,000 in the current taxable year for the non-conservation contributions (50% the $100,000 contribution base) and is allowed to carryover the excess $10,000 for up to 5 years. No current deduction is allowed for the qualified conservation contribution, but the entire $80,000 qualified conservation contribution may be carried forward for up to 15 years as a contribution subject to the 50% limitation.
**Farmers and Ranchers**

**Individuals**

In the case of an individual who is a “qualified farmer or rancher” for the taxable year of the contribution, the percentage limitation for qualified conservation contributions is increased to 100% of the donor’s contribution base over the amount of all other allowable charitable contribution deductions. In the above example, if the individual is a qualified farmer or rancher, in addition to the $50,000 deduction for non-conservation contributions, an additional $50,000 for the qualified conservation contribution would be allowed and $30,000 would be carried forward for up to 15 years as a contribution subject to the 100% limitation. Under an important exception applicable to contributions made after August 17, 2006, the increase of the percentage limitation from 50% to 100% for qualified farmers and ranchers does not apply where the property is used in agricultural and livestock production (or available for such production) unless the contribution is “subject to a restriction that such property remain available for such production.”

**Corporations**

In the case of a closely held C corporation that is a “qualified farmer or rancher” for the taxable year in which the contribution is made, qualified conservation contributions are allowed “to the extent the aggregate of such contributions does not exceed the excess of the taxpayer’s taxable income over the amount of the charitable contributions [otherwise] allowable.” Thus, under this provision, it may be possible for a qualified conservation contribution to shelter all of the taxable income of a C corporation that is a qualified farmer or rancher. As in the case of individuals, any excess may be carried forward for up to 15 years. Consistent with the requirement imposed on an individual who is a farmer or rancher, the closely held C corporation
will not be eligible for the enhanced deduction where the property is used in agricultural and livestock production (or available for such production) unless the contribution is “subject to a restriction that such property remain available for such production.” The enhanced deduction for qualified conservation contributions by closely held C corporations is not subject to limitations based on the value or income of the company or the number of shareholders. Thus, the available favorable treatment applies to closely held farming and ranching corporations, without regard to their value, annual income or number of shareholders.

III. Limitations on Deductibility of Charitable Contributions Under the Act

A. Modification of Recordkeeping and Substantiation Requirements for Certain Charitable Contributions

For contributions of $250 or more, a written contemporaneous acknowledgement under IRC § 170(f)(8) must be obtained from the donee organization in order for the contribution to be deducted. Prior to the Act, the minimum substantiation requirements for contributions less than $250 could be met where, in the absence of a canceled check or a receipt from the donee organization, the donor maintains “other reliable written records.” Such records included, for example, a contemporaneous diary or log entry stating the amount and the date of the donation and the name of the donee charitable organization. Under new IRC § 170(f)(17) contained in Section 1217 of the Act, no matter how small the amount involved, no deduction is allowed “for any contribution of a cash, check or other monetary gift unless the donor maintains as a record of the contribution a bank record or a written communication from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution.” Thus, for example, placing a $10 bill in a collection plate or basket is no longer deductible if the only evidence of the contribution is a contemporaneous diary or log entry. To ensure deductibility for
cash gifts less than $250, donors should obtain receipts from the donee charity, notwithstanding that a written contemporaneous acknowledgement under IRC § 170(f)(8) is not otherwise required. This new provision is effective for contributions made in taxable years beginning after August 17, 2006.

B. **Limitation on Charitable Deduction for Contributions of Clothing and Household Items**

New IRC § 170(f)(16) contained in Section 1216 of the Act provides that, effective for contributions made after August 17, 2006, no deduction is allowed for a charitable contribution of clothing or household items “unless the clothing or household item is in good used condition or better.” The IRS is authorized to deny by regulation a deduction for any contribution of clothing or a household item that has minimal monetary value, such as used socks and used undergarments.\(^{54}\) Household items are defined to include furniture, furnishings, electronics, appliances, linens, and other similar items.\(^{55}\) A deduction will not be disallowed under this new provision, however, for a charitable contribution of a single item of clothing or a household item which is not in good used condition or better if the amount of the deduction claimed for the item is more than $500 and the taxpayer includes with the taxpayer's return a qualified appraisal with respect to the property.\(^{56}\) Food, paintings, antiques, and other objects of art, jewelry and gems, and collections are specifically excluded from the definition of household items, thereby excluding contributions of such items from the purview of new IRC § 170(f)(16).\(^{57}\)

C. **Recapture of Tax Benefits for Contributions of Appreciated Tangible Personal Property Not Used for an Exempt Purpose**

Donors making charitable contributions of appreciated tangible personal property are subject to the rule that the available deduction otherwise based on the fair market value of the property must be reduced to the property’s tax basis where the use of the property by the donee
organization is unrelated to the purpose or function constituting the basis for its tax exemption under IRC 501(c)(3). Under existing regulations, a donor may treat a gift of tangible personal property as being put to a related use if (1) the donor establishes that the property is in fact put to a related use by the donee or (2) at the time of the contribution, it is reasonable to assume that the property will not be put to an unrelated use. Thus, for example, a donor may deduct the fair market value of a painting contributed to an educational organization that will display it in its library for study by its art students, but if the painting is contributed for the educational organization to sell and receive the sale proceeds, the deduction would be limited to the tax basis of the painting. To add teeth to the “related use” rules, Section 1215 of the Act amends IRC § 170(e) to provide that the donor is subject to an adjustment of the tax benefit for a deduction based on fair market value if the donee organization disposes of contributed tangible personal property within three years of the contribution. This new rule applies to appreciated tangible personal property identified by the donee organization on Form 8283, Noncash Charitable Contributions, as being put to a related use, and for which a deduction of more than $5,000 based on the property’s fair market value is claimed. If the disposition by the donee organization occurs in the tax year of the donor in which the contribution is made, the donor's deduction is equal to the tax basis of the property and not its fair market value. If the disposition occurs in a subsequent year, the donor must recapture as ordinary income in the taxable year in which the disposition occurs an amount equal to the excess of (i) the amount of the deduction previously claimed by the donor as a charitable contribution with respect to such property over (ii) the donor's tax basis in such property at the time of the contribution. An important exception to these new rules applies if the donee organization provides a written statement to the IRS, signed under penalties of perjury by an officer of the organization, which
(1) certifies that the use of the property was related to the purpose or function constituting the basis for the donee organization’s exemption, and describes how the property was used and how such use furthered such purpose or function, or (2) states the intended use of the property by the donee organization at the time of the contribution and certifies that such intended use became impossible or infeasible to implement.\textsuperscript{66} A penalty of $10,000 applies to a person that identifies property as having a related use knowing that it is not intended for such use.\textsuperscript{67} To conform the donee reporting requirements under IRC § 6050L to the new recapture provisions, Section 1215 of the Act also modifies the information return requirements that apply upon the disposition of contributed property by the donee organization. As a result, the requirement that the donee organization file Form 8282, Donee Information Return, is extended to dispositions made within 3 years after receipt from the 2-year period that applies under present law. This new provision is effective for contributions made and returns filed after September 1, 2006, and with respect to the $10,000 penalty, for identifications of related use property made after August 17, 2006.

In order to avoid the recapture provisions, donors should, to the extent possible, seek to obtain evidence prior to a contribution of tangible personal property of the donee organization’s intended use of the contributed property in furtherance of its exempt purposes, such as, for example, a board resolution or a letter from an officer or director, specifically indicating the intended exempt use of the property. For larger contributions made pursuant to a grant agreement, such agreement should indicate the intended exempt use of the property. At a minimum, donors should ensure, prior to the contribution, that the donee organization will indicate on Part IV of Form 8283 that the property will be put to a related use. Because of the impact on valuation issues, however, donors should generally avoid specifically limiting the use of the contributed property to the exempt purposes of the donee organization\textsuperscript{68} or placing
deaccessioning restrictions on the contributed property\textsuperscript{69} in order to avoid triggering the recapture provisions and the relating reporting obligations imposed on donee organizations where the contributed property is disposed of within 3 years of the contribution.

D. \textit{Contributions of Fractional Interests in Tangible Property}

In one of its most publicized and criticized provisions,\textsuperscript{70} Section 1218 of the Act makes dramatic changes to the rules applicable to contributions of fractional interests in tangible personal property, an increasingly popular means of giving to museums. These changes clearly create a substantial disincentive for donors to continue to contribute such interests and, as a result, Congress may be pressed to reconsider some of these changes.\textsuperscript{71}

\textit{Background}

Charitable contributions of fractional interests in tangible personal property, and particularly artwork, have become increasingly popular.\textsuperscript{72} Although a contribution of less than an entire interest in property is not deductible for income tax purposes, an exception is provided for a contribution of a partial interest that is less than the donor's entire interest in property if the partial interest is an undivided portion of the donor's entire interest, consisting of a fraction or percentage of each and every substantial interest or right owned by the donor in such property and extending over the entire term of the donor's interest in such property.\textsuperscript{73} Thus, a deduction is allowable under this exception if the donee organization is given the right, as a tenant in common with the donor, to possession, dominion, and control of the property for the portion of each year corresponding to its interest in the property. Under this authority, a donor may transfer, for example, a 50\% undivided interest in artwork to a museum, thereby giving the museum the right to possess the artwork 50\% of the days of each. Prior to the Act, there was no requirement that the donor transfer the remaining interest in the artwork during his lifetime or, for that matter, at
death. As a practical matter, however, contributing an undivided interest in artwork to a charity is generally limited to situations where the donor ultimately intends to contribute the remaining interest to the same charity. (Most museums won’t accept a fractional gift unless the donor agrees to give the remaining interests at some later date, including upon death.) The often mentioned Tax Court decision in Winokur\textsuperscript{74} indicates that it is the charity’s right to possession, not possession itself, that supports the charitable deduction. Thus, prior to the Act, there was no legal requirement that the donee museum actually take physical possession of the artwork.\textsuperscript{75} The IRS has ruled that a contribution of fractional undivided interests in works of art to a museum qualifies for a charitable deduction in an amount equal to the fair market value of the artwork multiplied by the fractional interest being contributed, thereby not resulting in a valuation discount as a result of fractional interest being conveyed.\textsuperscript{76} The technique of gifting fractional interests in artwork is ideal for an owner of artwork who resides at the specific location where the works are maintained only for a limited number of months during the year (who, presumably, resides in better climates for the other months) and who ultimately intends to make a testamentary disposition of the artwork to a museum.

\textit{Example}

A taxpayer owning an art collection resides in Pennsylvania, where the works of art are maintained, from May 1st to October 31st of each year. For the other six months of the year, he resides in Florida, where he would not otherwise be able to enjoy the paintings because they continue to be maintained in Pennsylvania during that period of time. Ultimately, the taxpayer intends to bequeath his collection to an art museum. The taxpayer could contribute a 50\% undivided fractional interest in specified paintings to the museum during his lifetime, under
an agreement with the museum whereby the taxpayer would have possession of
the artwork from May 1st to October 31st of each year and the museum would
have possession of the artwork for the remaining six months of the year. Under
this scenario, the taxpayer continues to enjoy the paintings as he always had, but
is also able to obtain valuable tax benefits during his lifetime attributable to the
income tax deductions for the value of the 50% undivided interests contributed to
the museum.

Changes to Contributions of Fractional Interests under the Act

Section 1218 of the Act makes significant changes to the existing income tax regime governing
contributions of fractional interests in tangible personal property, with such changes also having
application in the estate and gift tax context. 77

All interests must be owned by donor and donee.  No deduction is allowed for income or gift tax
purposes unless immediately before a contribution of a fractional interest in property by the
donor, all of the interests in the property are owned either (1) by the donor (in the case prior to an
initial contribution) or (2) by the donor and the donee organization (in the case following the
initial contribution). 78 Thus, if any party other than the donor and the donee organization holds
an interest in the property, a contribution of a fractional interest by the donor will be disallowed
for both income and gift tax purposes. The Secretary of the Treasury is authorized to issue
regulations providing for exceptions to this rule in cases where all persons who hold an interest
in the property make proportional contributions of a fractional interest of their entire interest to
the donee organization. For example, if Blake owns a 40% fractional percent interest in a
painting and Jeffrey owns a 60% fractional percent interest in the same painting, the regulations
may provide that Blake and Jeffrey may take a deduction for a charitable contribution of
fractional interest in the painting provided that they make proportional contributions of fractional interests in their respective shares of the painting to the same donee organization (e.g., Blake contributes a 20% fractional interest (50% of his entire interest) and Jeffrey contributes a 30% fractional interest (50% of his interest)).

Recapture of Tax Benefits Under 10-Year Rule. There is a recapture of the income tax and gift tax charitable deductions if, within 10 years of the date of the initial fractional interest or, if earlier, the donor’s death, the donor fails to contribute all of the remaining interest in the property to the same donee organization. There is also recapture of such deductions if, for the same period, the donee fails to take substantial physical possession of the property and use the property for a purpose or function constituting the basis for the organization’s tax exemption under IRC § 501(c)(3). Under these new rules, therefore, if a donor contributes an initial fractional interest in a painting to a museum and then fails to contribute all of his remaining interest to the same museum before the earlier of ten years from the initial fractional contribution or the donor's death, the donor’s income tax and gift tax deductions for all previous contributions of interests in the painting are recaptured. The recapture provision would also apply if, during this same period, the museum fails to take "substantial physical possession" of the property or fails to use the property for an exempt use, thereby overruling the Winokur case.

Fair Market Value of Subsequent Contributions Based on Value of Initial Contribution. For purposes of determining the fair market value of each additional contribution of a fractional interest in property following the initial contribution, the fair market value for purposes of determining the income, estate and gift tax purposes is the lesser of: (1) the value used for purposes of determining the charitable deduction for the initial fractional contribution; or (2) the fair market value of the property at the time of the subsequent contribution. Thus, any
appreciation in the property following the initial fractional contribution will be ignored for purposes of determining the charitable income tax deduction available for subsequent contributions, thereby limiting the value of any future income tax deduction. Moreover, because this new valuation rule applies to estate and gift tax charitable deduction, but not to the amount included in the gross estate or the taxable gifts, the subsequent appreciation of the property will result in negative estate and gift tax consequences. Thus, if a donor dies within 10 years of the contribution, the estate tax charitable deduction is limited to the value of the contribution of the initial fractional interest. For example, if a donor contributes a 25% interest in a painting worth $10,000,000 to a museum in 2007 (taking a $2,500,000 charitable income and gift tax deduction) and dies in the year 2014 when the painting is worth $20,000,000, the estate tax charitable deduction for the contribution of the remaining 75% fractional interest to the museum would be capped at $7,500,000, notwithstanding that the $15,000,000 value of the donor’s 75% interest in the painting is included in the donor’s gross estate. Thus, notwithstanding that the museum received a 100% interest in the painting during the requisite 10-year period, the donor’s estate is subject to estate tax in this situation on an additional $7,500,000.

Impact of New Rules

The appeal of making contributions of fractional interests of tangible personal property, such as artwork, has always been that a donor can continue to enjoy the property for a predetermined period of time each year during his or her lifetime and that the income tax deductions for subsequent contributions of fractional interests would be more valuable if the property appreciates in value. Taking away these advantages is likely to dissuade most donors from making contributions of fractional interests. Any donors otherwise willing to contribute the remaining interests in fractional interests within 10 years of the initial contribution and willing to
forgo the possibility of a greater income tax deduction still face a major deterrent against contributing fractional interests because of the potential negative estate and gift tax implications. Unless Congress makes changes to these new provisions, it is unlikely that donors will, in any event, be inclined to contribute fractional interests in tangible personal property.

**Effective Date of New Rules.**

The changes to contributions of fractional interests of tangible personal property are effective for initial contributions made after August 17, 2006. Thus, a contribution occurring prior to the date of enactment is not treated as an initial fractional. The JCT Technical Explanation states that where contributions of fractional interests have occurred before August 17, 2006, the first fractional contribution by a taxpayer after the date of enactment is considered the initial fractional contribution, regardless of whether the taxpayer had made a contribution of a fractional interest in the same item of tangible personal property prior to the date of enactment.\(^\text{83}\)

**E. Facade Easements**

**Background**

In a press release issued on December 17, 2004 by the Senate Finance Committee, Committee Chairman Grassley (R-Iowa) and ranking Democrat Baucus (D-Mont.) announced that they planned to introduce legislation that would increase and create additional fines and penalties on promoters, taxpayers and appraisers who participate, aid or assist in the donation of facade easements that are significantly overvalued for income tax purposes.\(^\text{84}\) The press release was in response to a series of articles appearing in the Washington Post in December 2004, “Loophole Pays Off on Upscale Buildings,” December 12, 2004, and “Tax Break Turns Into Big Business,” December 13, 2004, “A For-Profit Facade,” December 14, 2004, that examined the rapid growth in the donation of facade easements and the financial windfall they have bestowed on
homeowners, nonprofit trusts and for-profit companies that process the easements. Generally, where facade easements are donated, the property owner agrees that they will not change the outward appearance of their historic homes. They “contribute” this pledge, in the form of a restriction granted in perpetuity, as well as certain additional cash contributions to underwrite the cost of monitoring the restriction, to an historic preservation tax-exempt organization, and deduct the fair market value of the easement (as well as the cash contribution). Generally, the fair market value that is deductible is equal to the net decease in the value of the property subject to the facade easement caused by the restriction placed on the property in perpetuity. The Washington Post articles notes that preservation laws in the District of Columbia and elsewhere already forbid unapproved changes in the exterior of historic homes, which means that homeowners are collecting tax breaks for agreeing not to change something they are precluded from changing in the first instances. Although the amount deductible is supposed to represent the decline in the home's market value because of the facade restrictions, and they typically range from 10% to 15% of the property's value, the articles points out that real estate specialists said the easements generally do not hurt resale values, thereby making the tax incentives unwarranted. Homes with easements often are worth more than $1 million, and the write-offs routinely reach six figures, the Post analysis found, and nonprofit trusts that hold the easements and the for-profit companies they work with have collected millions of dollars in related fees and donations in recent years.

Changes to Contributions of Easements

The Act contains a number of reforms to address congressional concerns regarding deductions claimed for facade easements on building located in registered historic districts. Section 1213 of the Act substantially limits the availability of a charitable deduction for contributions of facade
easements for buildings located in a registered historic district by prohibiting a charitable deduction unless the easement conforms to the following requirements:

- The easement must include a restriction which preserves the entire exterior of the building, including the front, sides, rear, and height of the building), thereby denying a deduction for an easement that only protects the front facade of the building.

- The easement must prohibit any change to the exterior of the building that would be inconsistent with the historical character of such exterior, thereby denying a deduction where the easement does not contain sufficient restrictions to prevent damage or destruction to the historical character of the building.

- The donor and the easement-holding organization must enter into a written agreement certifying, under penalty of perjury, that the organization is a “qualified organization” with a purpose of environmental protection, open space preservation, or historic preservation, and that the organization has the resources to manage and enforce the easement’s restrictions and the commitment to do so.

- The donor must include with the return for the taxable year of the contribution a qualified appraisal of the qualified real property interest (irrespective of the claimed value of such interest), photographs of the entire exterior of the building, and descriptions of all current restrictions on development of the building, including, for example, zoning laws, ordinances, neighborhood association rules, restrictive covenants, and other similar restrictions.
• Taxpayers claiming a deduction for a qualified conservation contribution with respect to the exterior of a building located in a registered historic district in excess of $10,000 must pay a $500 fee to the Internal Revenue Service.

• The charitable deduction is reduced by the amount of any rehabilitation tax credit that has been claimed with respect to the donated property.

The Act also changes the definition of “certified historic structure” by removing the reference to “structure or land area” under IRC 170(h)(4)(B)(ii), although such language continues to apply under IRC 170(h)(4)(C)(i). Thus, under the Act, a “certified historic structure” now includes (1) under IRC 170(h)(4)(C)(i), “any building, structure or land area” which is listed in the National Register of Historic Places and (2) under IRC 170(h)(4)(C)(ii), “any building which is located in a registered historic district … and is certified by the Secretary of the Interior to the Secretary [of the Treasury] as being of historic significance to the district.” The effect of this change is to deny any deduction for contributions of easements that preserve non-building structures or land areas in registered historic districts where such structures or land areas not individually listed on the National Register under IRC § 170(h)(4)(C)(i). This change, for example, reduces the availability of a deduction for contributions of easements that preserve land areas that include battlefields, archaeological sites, and other historic landscapes, since many of these resources are located within registered historic districts (which may include non-building structures, such as monuments, fortifications and other similar structures of historic value). Such land areas may, however, qualify as “historically significant land area” under IRC § 170(h)(4)(A)(iv), the characterization of which is not dependent upon being listed in the National Register.
F. **Taxidermy**

The issue of abuses in connection with contributions of taxidermy property came to light in an April 14, 2005 front-page expose in the Washington Post, entitled “Big-Game Hunting Brings Big Tax Breaks.” According to the article, wealthy big-game hunters have been donating their trophies to pseudo-museums that agree to accept the donations, inflating their values and then taking hugely inflated tax deductions for their charitable contributions. One museum identified in the article as accepting these types of contributions was the Wyobraska Wildlife Museum, located in Gering, Nebraska, a modest and lightly visited facility, far from any population center. Behind the museum were more than 800 big-game and exotic animals piled in an old railroad car, just one of four containers packed with animal mounts and skins – trophies shot on expedition or safari to places such as South Africa, Mongolia and game-hunting parks in Texas. According to the article, in 2003, the museum sold $4.2 million in appraised mounts for less than $70,000 at true-market auctions. The article further states that “According to critics in Congress, top officials at natural history museums and animal rights advocates, this form of charitable giving allows wealth hunters to go on big-game expeditions essentially at taxpayer’s expense – an arrangement so blatant that one animal trophy appraiser advertises his services under the headline: “Hunt for Free.” The taxpayer subsidies also encourage hunters to track down and shoot the largest, fittest and rarest of the world’s largest animals, the critics say.” According to a press release, the Humane Society of the United States has weighed in on this issue, stating that “The Humane Society of the United States is urging taxpayers and tax preparers to think twice before claiming deductions for these dubious donations that are fleecing our treasury and encouraging trophy hunters to kill rare animals around the globe. The HSUS estimates that over 350,000 big game trophies entered the United States between 1998 and 2003. An unknown
number of those trophies were donated to pseudo-museums where they collect dust in storage or are on display in a hunter’s own living room. One facility, the Wyobraska Wildlife Museum in “Gering, Neb was found to have more than 800 big game and exotic trophy mounts in an old railroad car.” Senator Grassley has stated that the “phoniness of this kind of donation calls out for congressional action … it looks like it’s time for these self-enriching hunters to become the hunted.”

In response to such abuses, Section 1214 of the Act has added IRC § 170(e)(1)(iv), under which the amount allowed as a deduction for charitable contributions of taxidermy property that is contributed by the person who prepared, stuffed, or mounted the property, or by any person who paid or incurred the cost of such preparation, stuffing, or mounting, is the lesser of the taxpayer's basis in the property or the fair market value of the property. Under newly enacted IRC § 170(f)(15), “taxidermy property” is defined as any work of art that (i) is the reproduction or preservation of an animal in whole or in part, (ii) is prepared, stuffed or mounted for purposes of recreating one or more characteristics of such animal, and (iii) contains a part of the body of the dead animal. The basis of such property for this purpose is limited, as it includes only the cost of preparing, stuffing, or mounting the animal. Accordingly, basis does not include the costs of travel, transportation, or the direct or indirect costs relating to the hunting or killing of taxidermy property. This provision is effective for contributions made after July 25, 2006.

G. Valuation Penalties for Taxpayers and Appraisers

Taxpayer Penalties

Section 1219 of the Act significantly increase the scope of the accuracy-related penalties under IRC § 6662 in connection with the overvaluation of contributed property, including easements, by reducing the threshold for accuracy related taxpayer penalties for “substantial” and “gross”
valuation misstatements. The thresholds for determining whether a taxpayer has made a “substantial valuation misstatement” and a “gross valuation misstatement” for income tax purposes are now reduced, respectively, from 200% to 150% and from 400% to 200% of the amount determined to be the correct amount of the value of the property subject to the deduction. The Act also eliminates the existing “reasonable cause” exception under IRC 6664(c)(2) in the case of underpayments relating to substantial or gross valuation misstatements. Thus, taxpayers can no longer assert a defense to the imposition of accuracy-related penalties on the basis that that the claimed value of contributed property was based on a qualified appraisal and the taxpayer made a good faith investigation of the value of such property. These changes generally apply to returns filed after August 17, 2006, except in the case of a contribution of an easement or other conservation restriction on the exterior of a building located in a registered historic district, in which case these penalty changes are retroactive to returns filed after July 25, 2006.

Appraisal Penalties

The Act adds a new provision to the Internal Revenue Code, IRC § 6659A, which imposes penalties on any appraiser who “knows, or reasonably should have known” that an appraisal would be used in connection with a tax return or claim for refund and the claimed value of the property which is based on the appraisal results in a substantial valuation misstatement for income tax purposes or a gross valuation misstatement. The amount of the penalty is the lesser of (i) the greater of 10% of the amount of the underpayment attributable to the misstatement or $1,000, or (ii) 125% of the gross income received by the appraiser from the preparation of the appraisal. IRC § 6659(c) contains a limited exception to the penalty if the appraiser can establish that the value established in the appraisal was “more likely than not the proper value.”
These appraiser penalties are applicable with respect to appraisals prepared for returns filed after August 17, 2006, except that, as in the case of taxpayer accuracy-related penalties, they are retroactive to returns filed after July 25, 2006, in the case of a contribution of an easement or other conservation restriction on the exterior of a building located in a registered historic district.

IV. *Changes to Rules Governing Donor Advised Funds, Supporting Organizations and Private Foundations*

A. *Overview*

Although its impact on private foundations is rather limited, the Act makes sweeping changes to the rules governing donor advised funds and supporting organizations, including establishing a new penalty regime applicable to such organizations. Of particular note is that donor advised funds and supporting organizations are now, in certain cases, subject to more restrictive penalty provisions than other types of public charities, as well as private foundations, historically the most restricted variety of IRC § 501(c)(3) tax-exempt entities. In addition, Section 1226 of the Act indicates that more changes may be on the way, as it directs the Secretary of the Treasury to complete a study on the organization and operation of donor advised funds and supporting organizations not later than one year following the enactment of the Act and to make “such recommendations as the Secretary of the Treasury considers appropriate.” The Act creates an atmosphere of uncertainty in this area, as it specifically requires that the study consider such high profile issues as whether a charitable deduction should be allowed for contributions to donor advised funds and supporting organizations in the first instance, whether donor advised funds should be required to annually distribute a specified amount based on the income or assets of the fund, and whether the retention of advisory rights or privileges with respect to amounts transferred is consistent with the treatment of such transfers as completed gifts.\(^{91}\) The provisions under the Act affecting donor advised funds and supporting organizations are extremely complex
and administratively burdensome and, in the case of supporting organizations, makes an already
difficult to understand tax regime even that much more challenging. Given the new restrictions
imposed on supporting organizations, existing supporting organizations that qualify for public
charity status other than under IRC § 509(a)(3) may be best served by seeking reclassification.
Organizations sponsoring donor advised funds should institute procedures to ensure that they
adhere to the provisions of the Act and do not, therefore, unwittingly subject themselves, their
managers, donors, designated advisors and related parties to the new penalty excise taxes enacted
under the Act.

B.  

**Donor Advised Funds**

*Definition of Donor Advised Fund*

For the first time ever, the Internal Revenue Code provides a definition of the term “donor
advised fund,” an extremely important concept given that the provisions under the Act apply
only if, in the first instance, the fund involved meets the definition of a ”donor advised fund.”
Under new IRC § 4966(c)(2), a donor advised fund means a fund (1) which is separately
identified by reference to contributions of a donor or donors; (2) which is owned and controlled
by a sponsoring organization; and (3) with respect to which a donor or any person designated
by the donor has, or reasonably expects to have, advisory privileges with respect to the
distribution or investment of amounts held in such fund by reason of the donor’s status as a
donor.

*Separately Identified by Reference to Donor or Donors*

A fund will be considered separately identified by reference to the donor or donors only where it
refers to contributions of a donor or donors, such as by naming the fund after a donor, or by
treating the fund on the books of the sponsoring organization as attributable to funds contributed
by a specific donor or donors. Thus, a sponsoring organization’s general fund will generally not be treated as a donor advised fund because such fund is not typically separately identified by reference to contributions of a specific donor or donors. Similarly, a fund dedicated to specific purposes that attracts contributions from several donors but does not separately identify or refer to contributions of a donor or donors is not a donor advised fund even if a donor has advisory privileges with respect to the fund. A fund may not necessarily avoid donor advised fund status even where there is no formal recognition of contributions by a donor or donors on the books of the sponsoring organization if the fund operates as if contributions of a donor or donors are separately identified.

Owned and Controlled by Sponsoring Organization

Unless the sponsoring organization owns and controls a fund, it will not be considered a donor advised fund. Thus, to the extent that the donor or a third party other than the sponsoring organization controls amounts deposited with a sponsoring organization, a fund will not be considered a donor advised fund. Caution should be exercised, however, in having the donor or a third party retain control over a fund, as the retention of such control will prevent the transfer to the charity from being a completed gift, in which case no charitable deduction is available on the creation of the fund.

Advisory Privileges

The presence of advisory privileges may be evident through a written document specifically indicating that the donor or a person designated by the donor may provide advice to the sponsoring organization regarding distributions or investments. The presence of such privileges may also be evident through the conduct of a donor or an advisor and the sponsoring organization, such as the donor regularly providing advice and the sponsoring organization
regularly considering such advice.  

Advisory privileges are distinct from a legal right or obligation. Thus, where a donor retains legally enforceable rights pursuant to a gift agreement, the donor will not be treated as having “advisory privileges,” in which case the contributed funds will not be considered a donor advised fund. The retention of a legally enforceable right to direct distributions from a fund, as opposed to the mere right to recommend such distributions, will avoid donor advised fund status, although such a right would likely cause the fund to be considered a private foundation.

Statutory Exceptions to Donor Advised Funds

There are two exceptions whereby a fund that would otherwise be considered a donor advised fund is statutorily excluded from the definition of a donor advised fund. The first exception is a fund that makes distributions only to a single identified organization or governmental entity. Thus, for example, an endowment fund owned and controlled by a sponsoring organization that is held exclusively for the benefit of such organization is not a donor advised fund even if the fund is named after its principal donor and such donor has advisory privileges with respect to the distribution of amounts held in the fund. Accordingly, a donor that contributes to a university for purposes of establishing a fund named after the donor that exclusively supports the activities of the university is not a donor advised fund, even where the donor has advisory privileges regarding the distribution or investment of amounts held in the fund. A donor advised fund also does not include a fund that makes grants to individuals for travel, study or similar purposes if (i) the fund is advised by a committee all the members of which are appointed by the sponsoring organization, (ii) the committee is not controlled by the donor or advisor to the fund (or any related persons), and (iii) all grants from the fund are awarded on an objective and nondiscriminatory basis pursuant to procedures approved in advance by the governing board of
the sponsoring organization provided, however, that such procedures meet the requirements otherwise imposed on private foundations making such grants under IRC § 4945(g).

Excise Tax on “Taxable Distributions” Made by Donor Advised Funds

Section 1231 of the Act adds new IRC § 4966 (“Taxes on Taxable Distributions”) under which, effective for taxable years beginning after August 17, 2006, a 20% excise tax is imposed on the sponsoring organization on each “taxable distribution” from a donor advised fund. In addition, a 5% excise tax is imposed on such a distribution on a “fund manager” of the sponsoring organization who approves the distribution knowing it to be a taxable distribution, subject to a maximum tax of $10,000 for each taxable distribution. A taxable distribution includes a distribution to any individual, thereby providing an outright prohibition against donor advised funds making grants or any other distributions to individuals for any purpose. This prohibition would preclude, for example, providing scholarships to individuals or reimbursing individuals for otherwise bona fide expenses incurred in connection with a charitable event sponsored by a donor advised fund. This is contrary to the rules applicable to private foundations, which can grant scholarships in accordance with IRC § 4945(g) and reimburse individuals for reasonable and necessary expenses incurred on behalf of the foundation. A taxable distribution also includes a distribution made for any purposes other than a charitable, educational, religious or other exempt purpose delineated under IRC § 170(c)(2)(B). A taxable distribution will also result where a distribution, although made for an IRC § 170(c)(2)(B) purpose, is made to an organization that is not described in IRC § 170(b)(1)(A) unless the sponsoring organization exercises “expenditure responsibility” in accordance with the private foundation rules of IRC § 4945(h). Distributions made to public charities, therefore, as well as to the sponsoring organization, another donor advised fund or to a private operating foundation,
are not considered taxable distributions, without the need for the sponsoring organization to exercise expenditure responsibility.\textsuperscript{115} Because a private nonoperating foundation and certain other tax-exempt organizations are not described in IRC § 170(b)(1)(A), a distribution to such organizations, even solely for IRC § 170(c)(2)(B) purposes, constitutes a taxable distribution unless expenditure responsibility is exercised by the sponsoring organization. Distributions can also be made to a foreign organization but, in the absence of an IRS determination letter classifying it under IRC § 170(b)(1)(A) or an equivalency determination to that effect,\textsuperscript{116} expenditure responsibility is required to avoid taxable distribution treatment.\textsuperscript{117} Further, although supporting organizations are described under IRC § 170(b)(1)(A),\textsuperscript{118} unless expenditure responsibility is exercised, a taxable distribution will result where a distribution is made from a donor advised fund to a “disqualified supporting organization,” which includes (i) Type III supporting organization that is not a “functionally integrated Type III supporting organization” and (ii) a Type I, II or III supporting organization (even if functionally integrated) that is directly or indirectly controlled by the donor, an advisor to the fund, or any persons related to the donor or the advisor.\textsuperscript{119}

The new “taxable distribution” penalty regime clearly mandates that sponsoring organizations of donor advised funds be on guard and adopt policies to prevent taxable distributions from occurring. In addition to policies prohibiting any distributions from a donor advised fund to individuals or for a purpose other than one specified in IRC § 170(c)(2)(B), sponsoring organizations must now implement expenditure responsibility rules traditionally applied only to private foundations in cases where a distribution is made from a donor advised fund to an organization not described in IRC § 170(b)(1)(A). Policies applicable to distributions to supporting organizations should also be adopted to avoid taxable distribution treatment.\textsuperscript{120}
although prudence may dictate that sponsoring organizations simply adopt a policy requiring the
exercise of expenditure responsibility for all distributions to supporting organizations, thereby
removing any risk of such treatment.

Prohibition on Incidental Benefits

Section 1231 of the Act also adds new IRC § 4967 (“Taxes on Prohibited Benefits”) under
which, effective for taxable years beginning after August 17, 2006, an excise tax is imposed
where an advisor to a donor advised fund recommends a distribution that results in “a more than
incidental benefit,” whether directly or indirectly, to a (1) donor to the fund, (2) an advisor to the
fund, (3) a member of the family of the donor or advisor to the fund or (4) a 35% controlled
entity of such donor, advisor or family member. The excise tax equals 125% of the amount of
the benefit and is imposed against the advisor who recommended the distribution and the
recipient of the benefit, who are jointly and severally liable for the tax. In addition, a 10%
excise tax is imposed on such distribution on a “fund manager” of the sponsoring organization
who approves the distribution knowing that it would confer a more than incidental benefit on the
recipient, subject to a maximum tax of $10,000 for each such distribution. While not defined
under the Act, the JCT Technical Explanation provides that there is “a more than incidental
benefit” if the benefit, under the rules governing charitable contribution deductions under IRC §
170, would otherwise cause the reduction or elimination of a charitable contribution
deduction. Thus, a benefit that is not disregarded under IRC § 170, such as tickets to a
fundraising event, is subject to the new excise tax regime under IRC § 4967. The distinction
between the treatment of benefits received in connection with a contribution directly from a
donor versus a contribution from a donor advised fund is now quite significant. In the former
case, the charitable deduction otherwise available is merely reduced by the amount of the benefit
received, whereas in the latter case, the advisor to the fund and the fund manager are subject to significant excise taxes on the amount of such benefit. This new penalty regime creates another area where donor advised funds are subject to stricter rules than private foundations. Whereas fundraising tickets provided in connection with a distribution by a donor advised fund are subject to the new excise tax, the provision of the same tickets in connection with a grant by a private foundation is not strictly prohibited.126

“Excess Benefit” Transactions

Section 1232 of the Act amends the excess benefit transaction rules to add new IRC § 4958(c)(2) (“Special Rules for Donor Advised Funds”) under which, effective for transactions occurring after August 17, 2006, a grant, loan, compensation and other similar payment from a donor advised fund to a donor, an advisor to the fund or a related party is automatically considered to be an “excess benefit transaction.”127 The entire amount of the grant, loan, compensation or similar payment, therefore, is treated as an excess benefit, notwithstanding the value of the consideration provided in return for such payment.128 Thus, for example, under this “automatic excess benefit transaction rule,” notwithstanding that a family member of a donor may provide personal services to a donor advised fund which are reasonable and necessary in carrying out exempt purposes, the entire amount of the compensation paid in such a case is considered an excess benefit transaction, subjecting the family member and the organization manager of the sponsoring organization to excise taxes under IRC § 4958.129 Similarly, an expense reimbursement to such family member, even if related to charitable event for the benefit of a donor advised fund, will constitute an automatic excess benefit transaction.130 This penalty regime now imposes stricter rules on donor advised funds than those applicable to private foundations, given that reasonable compensation, including an expense reimbursement, may be
paid by a private foundation to a disqualified person under the self-dealing rules of IRC § 4941. The JCT Technical Explanation provides that other similar payments do not include a payment made pursuant to a bona fide sale or lease or property, thereby excluding payments made in connection with such transactions from the purview of the automatic excess benefit transaction rule. Thus, the sale of closely held stock by a donor advised fund to the donor or a related party does not result in an automatic excess benefit. Of particular importance, however, is that a donor, an advisor to the fund, an investment advisor with respect to the sponsoring organization, as well as related parties with respect to such persons, now fall under the category of “disqualified persons” under IRC § 4958. As a result, even in the absence of an automatic excess benefit, IRC § 4958 will apply if a transaction involving such persons is considered an “excess benefit transaction” because the economic benefit provided to the disqualified person exceeds the value of the consideration received in return. Thus, for example, if a family member of a donor purchases real property from a donor advised fund for $75,000, the transaction would not be treated as an excess benefit transaction if the fair market value of the property is actually equal to $75,000. Such a transaction would result, however, where the actual fair market value of the property exceeds $75,000.

Application of Excess Business Holdings Rule

Section 1233 of the Act applies the “excess business holdings rule” of IRC § 4943 to donor advised funds by providing, under new IRC § 4943(e)(1), that a donor advised fund “shall be treated as a private foundation” for purposes of IRC § 4943. As a result, effective for taxable years beginning after August 17, 2006, the holdings of a donor advised fund in any business enterprise are limited to 20% of the voting control of such entity less the amount of such holdings by “disqualified persons” with respect to such fund. Thus, if disqualified persons
with respect to a donor advised fund hold 20% or more of the voting stock of a corporation, a donor advised fund may not hold any voting stock of the corporation, as well as any nonvoting stock. In applying the excess business holdings rule to donor advised funds, a donor, an advisor to the fund, and any related parties are considered “disqualified persons.” A donor advised fund generally has up to 5 years to dispose of any excess business holdings resulting from a gift or bequest, although this period may be extended for another 5 years under certain circumstances. Transition rules apply to the present holdings of a donor advised fund similar to those of IRC § 4943(c)(4) through (6), generally allowing a donor advised fund to dispose of any excess holdings over a period of up to 20 years.

**New Deduction Rules for Charitable Contributions to Donor Advised Fund**

Section 1234 of the Act amends the charitable deduction provisions for income, gift and estate tax purposes to permit a charitable deduction for contributions to a donor advised funds only if the donor obtains a contemporaneous written acknowledgement from the sponsoring organization that such organization “has exclusive legal control over the assets contributed.” For inter vivos contributions of $250 or more, this acknowledgement would presumably made by the sponsoring organization within the contemporaneous written acknowledgement required under IRC § 170(f)(8). Further no charitable income, gift or estate tax deduction is allowed if the sponsoring organization of the donor advised fund is a Type III supporting organization that is not a functionally integrated Type III supporting organization, or where the sponsoring organization is described in IRC § 170(c)(3) (veterans’ organization), (4) (fraternal societies) or (5) (cemetery corporations).
C. **Supporting Organizations**

*Clarification of Relationship Requirement for Type I, II and III Supporting Organizations*

Section 1241 of the Act amends the language of IRC § 509(a)(3)(B) so that, instead of only one rather unclear sentence setting forth the required relationship between the three different types of supporting organizations and the supported organization, there are now three separate subsections defining such relationship.\(^{146}\) The three new subsections adopt the relationship requirements imposed under the existing regulations\(^{147}\) such that, notwithstanding the statutory changes, the relationship requirement remains the same, as follows:

- **Type I supporting organization** – operated, supervised, or controlled by one or more organizations described in IRC § 509(a)(1) or (2),\(^{148}\)
- **Type II supporting organization** – supervised or controlled in connection with one or more such organizations,\(^{149}\) or
- **Type III supporting organization** – operated in connection with one or more such organizations.\(^{150}\)

*Type I and Type III Supporting Organization Status Not Available Where Donor Controls Type I or III Supported Organization*

Prior to the Act, the control exercised over a supported organization by a contributor to the supporting organization was not relevant to the determination of the status of the supporting organization under IRC § 509(a)(3). Under newly enacted IRC § 509(f)(2) added by Section 1241 of the Act, effective on the date of the enactment of the Act, if a Type I or Type III supporting organization accepts any gift or contribution from a person (hereinafter “Controlling Donor”) who directly or indirectly controls, either alone or together with one or more related persons, the governing body of the supported organization, then the supporting organization will no longer qualify as a supporting organization under IRC § 509(a)(3).\(^{151}\) In such a case, unless
the organization can demonstrate that it qualifies as a public charity other than as a supporting organization, the organization will be considered a private foundation and, therefore, subject to all of the private foundation rules, including those limiting the charitable contribution deduction of donors under IRC § 170 and the excise tax rules of Chapter 42 of the Internal Revenue Code.\textsuperscript{152} Curiously, IRC § 509(f)(2) does not apply to Type II supporting organizations although, as discussed below, the excess business holdings rule of IRC § 4943 now applies to Type II supporting organizations that accepts any gift or contribution from a Controlling Donor. Of course, a Type I and Type II supporting organization that is treated as a private foundation by virtue of receiving a contribution or gift from a Controlling Donor is, by virtue of its private foundation status under IRC § 509(f)(2), subject to the excess business holdings rule.

\textit{Change in Classification Rules for Type III Supporting Organization Status}

A Type III supporting organization will only meet the “operated in connection with” standard if it meets the “responsiveness test” and the “integral part test.”\textsuperscript{153} Under the regulations, the responsiveness test is met in one or two circumstances. First, the responsiveness test is met where by way of interlocking officers, directors, or trustees or through the maintenance of a close and continuous working relationship, the officers, directors or trustees of the supported organization have a significant voice in the investment policies of the supporting organization, the timing of grants, the manner of making grants, investment policies, etc.\textsuperscript{154} Under the second method, the responsiveness test is met where (i) the supporting organization is a charitable trust under state law; (ii) each specified publicly supported organization is a named beneficiary under such charitable trust's governing instrument; and (iii) the beneficiary organization has the power to enforce the trust and compel an accounting under state law.\textsuperscript{155} The regulations provide two different circumstances under which the integral part test may be met. First, the test will be met
where the activities engaged in for or on behalf of the supported organization are activities to perform the functions of, or to carry out the purposes of, such organizations, and, but for the involvement of the supporting organization, would normally be engaged in by the supported organization.\textsuperscript{156} The second circumstance where the integral part test will be met is where the supporting organization "makes payments of substantially all of its income to or for the use of one or more publicly supported organizations, and the amount of support received by one or more publicly supported organizations is sufficient to ensure the attentiveness of such organizations to the operations of the supporting organization."\textsuperscript{157}

Under the Act, a Type III supporting organization that meets the integral part test due to the activities of the organization related to performing the functions of, or carrying out the purposes of, the supporting organization are now referred to as “functionally integrated type III supporting.”\textsuperscript{158} Type III supporting organizations meeting the integral part test only by virtue of making payments to a supported organization are not considered “functionally integrated.” This is an important distinction, as many of the new limitations imposed on Type III supporting organizations do not apply where the organization is considered a functionally integrated Type III supporting organization. The Act also adds new IRC § 509(f)(1)(A), entitled “Responsiveness,” which provides that for each taxable year beginning after the enactment of the Act, a Type III supporting organization will not meet the “operated in connection with” requirement unless it provides to each supported organization such information as the IRS may require to ensure that the supporting organization is responsive to the needs or demands of the supported organization. The JCT Technical Explanation indicates that such a showing could be met through the provision of the supporting organization’s governing documents, changes to the governing documents, the organization’s annual tax returns, an annual report of all of the support
provided and how such support was calculated.\textsuperscript{159} Section 1241(c) of the Act, which is noncodified provision, provides that an organization is not considered “operated in connection” a supported organization “solely because” it is (i) a charitable trust under state law, (ii) the supporting organization is a beneficiary of such trust; and (iii) the supported organization has the power to enforce the trust and compel an accounting. This provision is curious as, under existing law, the foregoing factors would only be sufficient to meet the responsiveness test, which is only one of two requirements needed to satisfy the “operated in connection with” test (the other being the “integral part” test). The JCT Technical Explanation sheds some light on this issue by providing that under this provision, a Type III supporting organization that is organized as a trust must, in addition to present law requirements, establish to the satisfaction of the IRS that it has a close and continuous relationship with the supported organization such that the trust is responsive to the needs or demands of the supported organization. Therefore, an existing Type III supporting organization that otherwise meets the responsiveness and integral part tests under present law must now, in addition, establish that it maintains a close and continuous relationship with the supported organization to continue to satisfy the “operated in connection with” requirement for Type III supporting organization status.

The Act also directs the Secretary of the Treasury to issue new regulations on payments required by Type III supporting organizations that are not functionally integrated, which “shall require such organizations to make distributions of a percentage of either income or assets to supported organizations … in order to ensure that a significant amount is paid to such organizations.” The JCT Technical Explanation indicates that “there is a concern that the current income-based payout does not result in a significant amount being paid to the charity if assets held by a supporting organization produce little to no income, especially in relation to the value
of the assets held by the organization, and as compared to amounts paid out by nonoperating private foundation.” Finally, under the Act, a Type III supporting organization may no longer support an organization that is not organized in the United States.\textsuperscript{160} Thus, U.S. "friends" organizations that are formed to support a specific foreign charity can no longer qualify as Type III supporting organizations. Such an organization should now consider qualifying as a public charity under IRC § 509(a)(1) as an organization described under IRC § 170(b)(1)(A)(vi), assuming that it receives sufficient public support.

“Excess Benefit Transaction” and Application of Excess Business Holdings Rule

Similar to the new rules applicable to donor advised funds, Section 1242 of the Act treats as an automatic excess benefit transaction any “grant, loan, payment of compensation, or similar payments” made by a Type I, II or III supporting organization to a “substantial contributor”\textsuperscript{161} or any related person with respect to a substantial contributor.\textsuperscript{162} A loan to a “disqualified person” with respect to a supporting organization is also considered an automatic excess benefit transaction, even if such person is not a substantial contributor or a related party.\textsuperscript{163} Section 1243 of the Act also applies the excess business holdings rule of IRC § 4943 to Type III supporting organizations that are not considered functionally integrated Type III supporting organizations.\textsuperscript{164} Such rules also apply to a Type II supporting organization that accepts any gift or contribution from a Controlling Donor.\textsuperscript{165} Disqualified persons in the context of a supporting organization consist of an expanded class of persons, including (1) any person in a position to exercise substantial influence over the affairs of the supporting organization, (2) a substantial contributor to the supporting organization, (3) related parties, (4) an organization that is effectively controlled by the same persons who control the supporting organization, and (5) an organization that has received substantially all of its contributions from a substantial contributor.
to the supporting organization, a related party, an officer, director or trustee of the supporting organization, or an owner of more than 20% of an entity that is a substantial contributor to the supporting organization.\textsuperscript{166}

\textit{Tax Return Disclosure Requirements}

Section 1245 of the Act makes several changes to the tax return disclosure requirements applicable to supporting organizations, effective for taxable years ending after August 17, 2006. Contrary to the existing requirements, all supporting organizations are required to annually file Form 990, regardless of the organization’s gross income,\textsuperscript{167} and the return must indicate whether the organization is a Type I, Type II or Type III supporting organization.\textsuperscript{168} The supporting organization must also “certify that the organization meets the requirements of section 509(a)(3)(B),” such that a supporting organizations is now required to demonstrate annually that it is not controlled directly or indirectly by one or more disqualified persons (other than foundation managers and other than one or more publicly supported organizations).\textsuperscript{169}

D. \textit{Private Foundations}

\textit{Increase In Chapter 42 Excise Taxes}

Section 1212 of the Act doubles the amount of most excise taxes imposed under Chapter 42 of the Internal Revenue Code on private foundations, foundation managers and disqualified persons, effective for taxable years beginning after August 17, 2006. The excise taxes subject to this increase are those imposed on acts of self-dealing under IRC § 4941,\textsuperscript{170} the failure to satisfy the 5% minimum distribution requirement under IRC § 4942,\textsuperscript{171} excess business holdings under IRC § 4943,\textsuperscript{172} investments that jeopardize charitable purposes under IRC § 4944\textsuperscript{173} and taxable expenditures under IRC § 4945.\textsuperscript{174}
Grants to Type III Supporting Organizations and Controlled Supporting Organizations

Prior to the Act, a distribution by a nonoperating foundation to all IRC § 509(a)(3) supporting organizations constituted a “qualifying distribution” under IRC § 4942(g) and was not considered a “taxable expenditure” under IRC § 4945(d). Section 1244 of the Act amends IRC § 4942(g) to provide that distributions by a private nonoperating foundation after August 17, 2006 to Type III supporting organizations that are not functionally integrated Type III supporting organizations are not considered “qualifying distributions.”

Thus, a distribution to such organizations is no longer applied against the distribution requirement imposed on a private nonoperating foundation that it make annual qualifying distributions generally equal to at least 5% of the fair market value of its assets. Moreover, IRC § 4945(d)(4) has been amended to provide that such a distribution constitutes a “taxable expenditure” unless the private foundation exercises “expenditure responsibility” in accordance with IRC § 4945(h).

The same rules apply where a private nonoperating foundation makes a distribution to a Type I or II supporting organization, as well as a functionally integrated Type III supporting organization, if a disqualified person with respect to the foundation directly or indirectly controls the supporting organization or a supported organization of such supporting organization. In such a case, therefore, no qualifying distribution results and, unless expenditure responsibility is exercised, a taxable expenditure will occur.

Expansion of Tax on Net Investment Income

For purposes of the excise tax imposed on the net investment income of a private foundation, IRC § 4940(c)(2) provides that the term “gross investment income” means the gross amount of income from interest, dividends, rents, payments with respect to securities loans, and royalties. In response to the strict reading of IRC § 4940(c)(2) applied in the Zemurray case, effective for
taxable years beginning after August 17, 2006, Section 1221 of the Act amends IRC § 4940(c)(2) to provide that “gross investment income” shall also include “income from sources similar” to the those enumerated in the preceding sentence. Such similar sources of income include income from notional principal contracts, annuities, and other substantially similar income from ordinary and routine investments. The definition of capital gain income is similarly expanded, although under rules similar to IRC § 1031, no gain or loss is taken into account with respect to any property used by a private foundation for exempt purposes for at least one year if the entire property is exchanged for like-kind that is used for such purposes.

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2 There is a wave of noteworthy examples. On January 30, 2003, the Charity, Aid, Recovery and Empowerment (“CARE”) Act of 2003 was introduced containing several tax incentives to encourage charitable giving, including a charitable deduction for non-itemizers and an IRA charitable rollover provision. This bill was similar to the CARE Act of 2002 that was originally introduced in 2001, but which failed to be enacted in 2002 during the 107th Congress. The Care Act of 2003 was passed by the Senate on April 9, 2003, as S. 476, and the House’s version of the Care Act, H.R. 7, was passed on September 17, 2003, although no conference was ever held to resolve the differences between the two bills during the 108th Congress and the Care Act of 2003 was never passed. Following the release of a Staff Discussion Draft, on July 22, 2004, the Senate Finance Committee held a highly publicized hearing to focus on governance and best practices of charitable organizations, which also focused on various abuses in the charitable sector, including such things as inflated charitable deductions and donor-advised funds and supporting organizations being used for noncharitable purposes. On January 27, 2005, the Joint Committee on Taxation (“JCT”) issued a report, entitled “Options to Improve Compliance and Reform Tax Expenditures,” which was developed by the JCT staff at the request of Senator Charles Grassley (R-Iowa), Chairman of the Senate Finance Committee, and Senate Max Baucus (D-Mont.), the ranking Democratic member. This report contained a number of proposals affecting donors to charities, as well as the charities themselves. On April 5, 2004, the Senate Finance Committee held a second hearing on nonprofit organizations and charitable giving, focusing on ways to strengthen nonprofit governance and reduce various perceived improprieties in charitable giving, which was followed by a hearing by the House Ways and Means Committee on April 20, 2005. At the request of Senate Grassley, a Panel on the Nonprofit Sector was created in October 2004, which issued an interim report on May 1, 2005 and a final report on June 22, 2005, containing a comprehensive series of recommendations intended to strengthen the ability of the nation’s 1.3 million charities and foundations to serve as responsible stewards of the public’s generosity. Finally, the Senate passed S. 2020 on November 18, 2005, which contained a number of charitable giving incentives and reforms, while the House’s version of the same bill, H.R. 4297, contained no such provisions. The charitable provisions were dropped from the legislation ultimately passed by the full Congress and signed into law by the President on May 17, 2006 as the “Tax Increase Prevention and Reconciliation Act.”

3 Certain more limited charitable giving incentives and reforms have, however, been enacted in the last two years. Under Section 301 the Katrina Emergency Relief Act of 2005 (“KETRA”), the 50% gross income limitation under IRC § 170(b) was temporarily suspended for certain cash contributions and an enhanced deduction for contributions of food and book inventory was temporarily provided. Under the American Jobs Creation Act of 2004, effective for contributions after December 31, 2004, the amount of the deduction available for charitable contributions of vehicles
generally cannot exceed the gross proceeds received from the sale, and, effective for contributions made after June 3, 2004, the amount of the deduction for contributions of patents or other intellectual property is generally limited to certain amounts received by the charity with respect to the contributed property.

4 The Act was passed by the House and the Senate, respectively, on July 28 and August 3, 2006. On August 3, the JCT released a technical explanation of the Act (“JCT Technical Explanation”), a 376 page report. The date of the enactment of the Act is August 17, 2006, the date the Act was signed into law by the President (references hereinafter to the “date of the enactment of the Act,” therefore, are to August 17, 2006). Notwithstanding its name, the Act contains charitable incentives and reforms, which were passed as part of the pension reform legislation, rather than as separate, independent legislation. In a July 24, 2006 letter to President Bush, Independent Sector expressed its view that the “pension reform legislation represents the best opportunity this year to pass these incentives and reforms that will provide important benefits to charitable organizations and support strong ethical conduct within the charitable community.” An August 4, 2006 press release by Senator Grassley states that the “pension bill includes a good package of charitable giving incentives and loophole closers. It makes sense to tighten areas of abuse while increasing incentives for charitable giving.”

5 A front page article in the New York Times on April 25, 2005, entitled “Big Tax Break Often Bypasses Idea of Charity,” presents a highly critical view of supporting organizations, which was followed by a joint press release issued by Senators Grassley and Max Baucus stating that they plan to propose reforms “to stop the use of supporting organizations for generous tax breaks rather than charitable purposes.” Donor advised funds have similarly come under criticism. In News Release 2004-81 (June 22, 2004), IRS Commissioner Mark W. Everson stated that “the IRS is aware that some promoters encourage clients to donate funds and use those funds to pay personal expenses, which might include school expenses for the donor’s children, payments for the donor’s own ‘volunteer work,’ and loans back to the donor.”

6 For example, S. 2020 contained minimum distribution requirements applicable to both the sponsoring organization and each individual donor advised fund. S. 2020 would have also increased the payout requirements for Type III supporting organizations, generally equal to the greater of 85% of investment income or 3% of the fair market value of assets. A Staff Discussion Draft released by the Senate Finance Committee prior to its July 22, 2004 hearing on governance and best practices of charitable organizations proposes the eliminate of Type III supporting organizations, as “[t]his has been an area of significant abuse.”

7 There are only five charitable giving incentives under the Act, which are contained in Subtitle A of Title XII, entitled “Charitable Giving Incentives.” These incentives and the corresponding section number of the Act are as follows: (1) the “IRA charitable rollover” provision (Section 1201); (2) extension of the enhanced deduction for contributions of food inventory under KETRA from December 31, 2005 to December 31, 2007; (3) special basis adjustment to S corporation stock for charitable contributions by S corporations (Section 1203); (4) extension of the enhanced deduction for contributions of book inventory under KETRA from December 31, 2005 to December 31, 2007 (Section 1204); and (5) increasing the IRC § 170(b) percentage limitations for contributions of capital gain real property made for conservation purposes (Section 1206).

8 Preliminary estimates by the United Way of America indicate that this new provision could generate an additional $400 million in new giving to the charitable sector each year. Other organizations, such as Independent Sector, anticipate an even larger amount of giving attributable to this provision. See “New Bill May Boost Charitable Giving,” Wall Street Journal, p. D2, August 9, 2006. A letter from a number of organizations, including Independent Sector, to the Senate Finance Committee and the House Ways and Means Committee dated February 27, 2006, urging the passage of the IRA charitable rollover provision, states that “according to a recent Investment Company Institute report, there were an estimated $3 trillion in assets held in IRA accounts at the end of 2003. Even if only a small percentage of these funds were donated to charitable purposes, it could add billions of dollars to support the vital work of nonprofit organizations.”
Carving out donor advised fund and supporting organizations from the IRA charitable rollover provision is consistent with the charitable giving incentives previously provided under KETRA, as the temporary suspension of the 50% gross income limitation provided under Section 301 of KETRA specifically did not apply to contributions to donor advised funds (including those maintained in community foundations) or supporting organizations. In a Statement on the Enactment of H.R. 4 issued on August 4, 2006, the President and the CEO of the Council on Foundations (“COF”), after stating that Congress does not understand the important role of donor advised funds and supporting organization, “urges Congress to quickly amend the law to extend the IRA charitable rollover to donor-advised funds and supporting organizations when they return in September.” The COF has also issued an Issue Paper, entitled “Extend Charitable Rollover to Donor-Advised Funds, Supporting Organizations and Private Foundations.”

For example, S. 2020, passed by the Senate on November 18, 2005, and amended on February 2, 2006, permitted tax-free transfers from an IRA to split-interest entities, such as charitable remainder trusts, pooled income funds, and charitable gift annuities, beginning upon the taxpayer attaining age 59 1/2. Transfers to such split-interest entities to do not qualify for tax-free treatment under the Act, no matter what the age of the taxpayer.

Clearly, the charitable sector will look to have the IRA rollover provision extended beyond 2007, increase the annual $100,000 cap, and to expand the eligible recipients to include donor advised funds, supporting organizations and split-interest entities.

Note that S. 2020, discussed above, provided for a charitable deduction for cash donations made by taxpayers who do not itemize their deductions. That bill created a floor of $210 for single filers ($420 for joint filers) that applied to both taxpayers who do not itemize and those that do itemize. The Act also does not allow artists to deduct the fair market value of contributions of literary, musical, artistic, or scholarly property, leaving in place the present law provision that limits the deduction to the income tax basis of such property, essentially equal to the cost of materials, such as paint and canvas. Prior to the present law limitation, enacted as part of the Tax Reform Act of 1969, artists and collectors alike were able to take a deduction equal to the fair market value of the work. Since that time, fewer and fewer artists have donated their works of art to museums and cultural institutions, given that the existing tax regime offers either no or very little incentive to contribute such works. The sharp decline in the donations to the Library of Congress illustrates this point. Until 1969, the Library of Congress received 15 to 20 large gifts of manuscripts from authors each year. In the four years following the elimination of the fair market value deduction, the Library of Congress received only one such gift. Instead, many of these works have been sold to private collectors and are no longer available to the general public.

Note that the Act also extends the KETRA enhanced charitable deduction for food and book inventory through December 31, 2007, which is not discussed below. In doing so, the Act extends the provision under KETRA, codified as IRC § 170(e)(3)(D)(iv), through December 31, 2007, which expanded the pre-KETRA enhanced deduction for C corporations to include “qualified book contributions.” The Act also extends the provision under KETRA, codified as IRC § 170(e)(3)(C)(iv), through December 31, 2007, which expanded the pre-KETRA enhanced deduction for certain food donations.

Contrary to funding lifetime charitable giving, funding testamentary contributions from an IRA and other retirement plans has traditionally been an excellent choice for donors, given that an IRA constitutes “income in respect of a decedent” under IRC § 691, which is subject to income tax in the hands of a noncharitable beneficiary but not in the hands of a charitable beneficiary.
Many IRA administrators allow an account holder to direct a payment from the account to a third-party designee, including a charity, generally conditioned upon the account holder providing a signature guarantee. Absent the IRA charitable rollover provisions under the Act, a distribution to a third-party designee in such a case subjects the account holder to the same federal income tax consequences that apply where the funds are first withdrawn by the account holder and then transferred to charity, as income cannot be assigned to a third party.

Generally, a distribution from an IRA that is not a Roth IRA is taxed to the recipient as ordinary income in the taxable year in which the distribution is received and, therefore, is included in gross income for such year. IRC § 408(d)(1). Where, however, an IRA account owner previously made nondeductible contributions to the IRA, a portion of a distribution from the IRA constitutes a tax-free return of such contributions. IRC § 408(d)(1) (adopting the principles of IRC § 72).

This is contrary to the situation where a donor uses assets held outside an IRA, including appreciated assets, to fund a charitable contribution where not only is income not realized as a result of the contribution, but the contribution shelters other income of the donor, thereby resulting in overall tax savings.

The 50% maximum limitation generally only applies to cash contributions and contributions of property where the deduction is limited to basis where such contributions are made to public charities. Other contributions are subject to either a 30% or 20% limitation based on gross income. Any deduction in excess of the IRC § 170(b) limitations can be carried forward for up to five succeeding taxable years.

In this situation, if the gross income were $200,000, then the $100,000 charitable contribution funded by the IRA withdrawal would not be limited by the 50% gross income limitation imposed under IRC § 170(b), although any additional contributions by the donor would then become subject to such limitation.

These include, for example, the 3% phase-out of itemized deductions under IRC § 68, the 2% limitation for miscellaneous deductions under IRC § 67, the 7.5% limitation on medical deductions under IRC § 213, and the 10% casualty loss deduction under IRC § 165(h). Note also that the personal exemption is phased out based on a taxpayer’s gross income. IRC § 151(d)(3).

IRC § 86(b).

IRC § 55(d).

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In such a case, therefore, the distribution would be subject to inclusion in the gross income of the account holder and the charitable contribution deduction would be subject to the percentage limitations imposed on charitable contributions under IRC § 170(b), as well under IRC § 68(b).

Query, for example, whether an IRA administrator would make rollover distributions at the request of an account owner of $50 to 2,000 different charities. The likely result will be the IRA administrators will impose certain minimum thresholds for such distributions and, if any event, impose certain processing fees or charges.
Note that in a letter dated August 28, 2006 from the Securities Industry Association to the Treasury Department (“Securities Industry Association Letter”) seeking guidance on the IRA charitable rollover provision, it specifically states that “our members would also like confirmation that the IRA trustee/custodian has no obligation or duty to investigate or confirm that the charity meets the requirements in Sec. 1201 and that we can rely on the taxpayer’s own instructions.”

These rules are contained within new IRC § 408(d)(8)(A) through (E), as added by the Act.

Also included under IRC § 170(b)(1)(A) are private operating foundations and pass-through private nonoperating foundations. IRC § 170(b)(1)(A)(vii).

Note that the Securities Industry Association Letter asks “would a client that was provided check-writing privileges on an IRA account meet the requirements for a transfer?” Presumably, where such a check is made payable to a qualified charity, the distribution from the IRA should be considered as made directly to the charity.

Benefits attributable to the receipt of token items that are otherwise disregarded (and, therefore, deemed to have no fair market value) under the charitable contribution deduction rules would not be taken into account for this purpose. The JCT Technical Explanation, at p. 267, specifically provides that charitable rollover treatment is not available where, under present law, the “deductible amount is reduced because of a benefit received in exchange.”

The JCT Technical Explanation, at p. 267, specifically provides that charitable rollover treatment is not available where the donor does not obtain sufficient substantiation under present law.

IRC § 408A(d)(2)(B).

This provision has only limited application, as it only impacts shareholders of S corporations. Although the taxpayers affected but this change may be limited in number, the size of the contributions made by S corporations could be substantial.

IRC §§ 1366(a)(1)(A) (S corporation shareholder) and 702(a)(4) (partner).

IRC § 1366(d)(1).

Rev. Rul. 96-11, 1996-1 C.B. 140 (holding that if a partnership makes a charitable contribution of property, the basis of each partner’s interest in the partnership is decreased (but not below zero) by the partner’s share of the partnership’s basis in the property contributed, rather than the partner’s share of the fair market value of the property contributed).

This amendment is contained in Section 1203 of the Act (“Basis Adjustment to Stock of S Corporation Contributing Property”).

The changes made by the Act in this area, which are contained in Section 1206 (“Encouragement of Contributions of Capital Gain Real Property Made for Conservation Purposes”), are incorporated into the Internal Revenue Code.
by redesignating existing IRC § 170(b)(1)(E) and (F) as, respectively, IRC § 170(b)(1)(F) and (G), and including the new rules for contributions of capital gain real property made for conservation purposes in IRC § 170(b)(1)(E).

39 A qualified conservation contribution, defined in IRC § 170(h)(1), is a contribution of a “qualified real property interest” (defined in IRC § 170(h)(2)) to a “qualified organization” (defined in IRC § 170(h)(3)) exclusively for conservation purposes (defined in IRC § 170(h)(4)). Most qualified conservation contributions are easements transferred to local, community-based charities that are devoted to maintaining lands for agricultural purposes, conserving wildlife habitats, or protecting open space and historic property.

40 A qualified conservation contribution generally involves the contribution of a capital asset. This assumes that the underlying property has been held more than one year, has appreciated in value and that the special election under IRC § 170(b)(1)(C)(iii) to deduct the property’s basis, rather than its fair market value, has not been made.

41 The fair market value of a conservation restriction granted in perpetuity generally is determined under the "before and after approach." Such approach provides that the fair market value of the restriction is equal to the excess (if any) of (i) the fair market value of the property the restriction encumbers before the restriction is granted over (ii) the fair market value of the encumbered property after the restriction is granted. Treas. Reg. § 1.170A-14(h)(3).

42 The 30% limitation generally applies where the deduction is based on the fair market value of the property. The “contribution base” is defined as the individual's adjusted gross income for the taxable year, computed without regard to any net operating loss carryback to the taxable year under IRC § 172. IRC § 170(b)(1)(G) (as redesignated under the Act).

43 Under the order of priority rules contained in IRC § 170(b), in applying the 50%, 30% and 20% percentage limitations on charitable contributions for each taxable year, contributions to public charities subject to the 50% limitation are deducted first, with contributions subject to the 30% and 20% percentage limitations deducted thereafter.

44 Thus, in any given taxable year, prior to deducting qualified conservation contributions, all other contributions subject to either the 50%, 30% or 20% limitation are taken into account first.

45 For individuals and corporations, the new rules for qualified conservation contributions do not apply to contributions made in taxable years beginning after December 31, 2007. Given the short window for making the contribution and the protracted period of time generally required in order to effectuate contributions of conservation easements, in certain cases it may be difficult to achieve the benefits provided by the new rules.

46 “Qualified farmer or rancher” means a taxpayer whose gross income from the trade or business of farming (within the meaning of IRC § 2032A(e)(5)) is greater than 50% of the taxpayer’s gross income for the year. IRC § 170(b)(1)(E)(v) (as added by the Act).

47 Note that this condition does not require that the property has to be used for agricultural and livestock production, only that it “remain available for such production.” Contributions made from January 1, 2006 through August 17, 2006 are not subject to this condition.
Such a corporation includes a corporation “the stock of which is not readily tradable on an established securities market at any time during such year.” IRC § 170(b)(2)(B)(i)(I) (as added by the Act).

IRC 170(b)(2)(B)(i) (as added by the Act).

As in the case of individuals, contributions made from January 1, 2006 through August 17, 2006 are not subject to this condition.

Even where IRC § 170(f)(8) applies, however, for contributions of money, cancelled checks should be maintained, although the cancelled check alone will not satisfy the written contemporaneous acknowledgment requirement.

Reg. §1.170A-13(a)(1).

Reg. §1.170A-13(a)(2). This regulation also provides that the IRS will accept other evidence of a small contribution, such as receiving an emblem, button, or other token traditionally associated with a small cash gift to a charitable organization.

IRC § 170(f)(16)(B) (as added by the Act).

IRC § 170(f)(16)(D)(i) (as added by the Act).

IRC § 170(f)(16)(C) (as added by the Act).

IRC § 170(f)(16)(D)(ii) (as added by the Act).

IRC 170(e)(1)(B)(i). This provision was enacted under the 1969 Tax Reform Act.

Reg. 1.170A-4(b)(3). This regulation further provides that in the case of a contribution to a museum, if the object donated is of a type normally retained by such museum or other museums for museum purposes, it will be reasonable for the donor to anticipate, unless he has actual knowledge to the contrary, that the object will be put to a related use, whether or not the object is later sold or exchanged by the donee organization. The “related use” rule has the obvious intent of encouraging contributions of tangible personal property to those organizations that will actually utilize the property to carry out their exempt purposes to the good of our society, rather than simply using utilizing the property to raise money. See Statement of Edwin S. Cohen, Assistant Secretary of the Treasury for Tax Policy, Hearings on H.R. 13270 Before the Senate Finance Committee on Finance, 91st Cong., 1st Sess., pt. 1, at 570-71 (1969). For a excellent discussion of the “related use” requirement and the legislative history, see Anthoine, “Deductions for Charitable Contributions of Appreciated Property – The Art World, 35 Tax L. Rev. 239 (1980).

This assumes that the educational organization is a public charity under IRC § 170(b)(1)(A) and that the painting is capital gain property.

Such identification is indicated on Part IV, Donee Acknowledgment, of Form 8283. Prior to making a contribution of tangible personal property to a donee organization, donors should confirm that the donee will, in fact, indicate on Part IV of Form 8283 that the property will be put to a related use, assuming that is the donor’s understanding and intent.

See IRC § 170(e)(7)(C) (as added by the Act), defining such property as “applicable property.”

IRC § 170(e)(1)(B)(i)(II) (as added by the Act).

IRC § 170(e)(7)(A) (as added by the Act).

IRC § 170(e)(7)(D) (as added by the Act). The Act does not contain a standard for determining whether a related use “became impossible or infeasible,” although guidance on this issue will likely be provided by the IRS.

IRC § 6720B (“Fraudulent Identification of Exempt Use Property”) (as added by the Act).

In Rev. Rul. 85-99, 1985-2 C.B. 2, for example, an agricultural college sought to acquire a certain parcel of land to use in connection with its operations in farming research and development of new farming techniques. Although the highest and best use of the contributed property, if unrestricted, would have been for a more valuable use than as agricultural land, the owner contributed the land under a deed of gift that carried a restrictive covenant providing that the land could be used only for agricultural purposes. The IRS stated that property that is encumbered by some restriction or condition limiting its marketability or use must be valued in the light of such limitation. Thus, the IRS ruled that the amount of the taxpayer donor's charitable contribution deduction for income tax purposes was the fair market value of the property at the time of the contribution determined in the light of the restriction placed by the donor on the use of the property, rather than its higher unrestricted value.

In Silverman v. Com’r, T.C. Memo. 1968-216, the Tax Court was faced with an issue involving the valuation of 148 paintings for income tax purposes contributed by an individual over a five-year period. Each gift of artwork was subject to a condition that the donee organization not dispose of the paintings for a three-year period. The court agreed with the taxpayer’s position that a restriction against sale or disposition of a painting for a fixed period of time is not of as great importance as a like restrictions on securities or other property of fluctuating value. The court held, however, that such a restriction was more than of negligible significance and, as such, was taken into account in the court’s final determination of the amount of the available contribution deduction. The court stated that the three-year prohibition on sale “certainly had an adverse effect on fair market value.”

For example, in a letter dated August 1, 2006, the Museum Association of New York (“Museum Association Letter”) states that the provision of the Act affecting contributions of fractional interests is an “ill-considered and deeply impractical provision [that] would discourage donors from giving and create significant, pointless burdens for museums. This is truly an instance where we ought not try to fix what is not broken: existing law works because it encourages charitable giving to America’s superb museums. Changes are unnecessary and could be the death knell of this effective means of giving.”
See, e.g., “Museums Fear Tax Law Changes on Some Donations,” New York Times, E1 (September 13, 2006) (“Directors and trustees of the nation’s top art museums are preparing a major lobbying effort to reverse a federal tax provision approved last month that they say will significantly harm their ability to acquire new artworks”). In that same article, Senator Charles E. Grassley, the Chairman of the Senate Finance Committee, states “It isn’t right for a donor to get a big tax break for supposedly donating a painting that lands in his living room, not the museum, all year. A painting in a private living room doesn’t benefit the public.”

A recent Wall Street Journal article, entitled “Joint Custody For Your Monet” (July 6, 2005), indicates that an increasing number of art collectors are giving museums a share of their most valuable works of art, rather than donating an entire painting or a collection at all at once. The article notes that a number of the nation’s most prominent museums, including the Museum of Modern Art in New York, Boston’s Museum of Fine Arts, and Washington’s Hirshorn Museum of Sculpture Garden are actively using the strategy to court potential donors and, in some cases, promoting it on their Web sites. Museums are stressing the tax advantages of contributions of fractional interests. One point, the article notes, is that contributing a fractional interest is advantageous when an outright gift, based on 100% of its value, would not be fully deductible because the deduction is limited to 30% of adjusted gross income and may only be carried over for 5 years. Donating fractional interests allows for the 30% limitation to be “managed,” so that the maximum available deduction is obtained over time.

IRC § 170(f)(3)(B)(ii) and Reg. § 1.170A-7(b)(1).

90 TC 733 (1988).

The Museum Association Letter specifically notes that as follows with respect to the issue of a charity’s physical possession: “For a variety of reasons, museums do not always exercise their right of possession in a particular year. Some works—especially those on paper—are too fragile to be moved frequently. Others are too large to be moved frequently: imagine, for example, having to move works by the American sculptor Richard Serra; tons of fabricated steel would have to be de-installed by trained professionals, shipped at enormous expense, and then stored at the museum—only to reverse the process to return it to the donor. There are other costs, too, notably insurance and the professional staff involved in transporting art with museum standards of care. Finally, a museum may not wish to install a particular work in a particular year or years.”

See, e.g., Rev. Rul. 57-293, 1957-2 CB 153; Ltr. Rul. 200223013. A deduction based on the fair market value of a contribution of artwork requires, however, that the donee organization use the artwork for a related use, as discussed above.

The changes made by the Act contained in Section 1218 (“Contributions of Fractional Interest in Tangible personal Property”) are incorporated into the Internal Revenue Code by amending the applicable provisions allowing a charitable deduction for income, estate and gift purposes, as follows: (i) income tax: existing IRC §170(o) is redesignated as IRC § 170(p) and the new rules regarding contributions of fractional interests are now contained in IRC § 170(o); (ii) estate tax: existing IRC §2055(g) is redesignated as 2055(h) and the new rules regarding contributions of fractional interests are now contained in IRC § 2055(g); (iii) gift tax: existing IRC §2522(e) is redesignated as IRC § 2522(f) and the new rules regarding contributions of fractional interests are now contained in IRC § 2522(e).

IRC §§ 170(o)(1)(A) (income tax); 2522(e)(1)(A) (gift tax) (as added by the Act). In the event of a bequest of a fractional interest, an estate tax charitable deduction under IRC § 2055 would still be available, even if the donor and the donee charitable do not own all of the interests in the property.
IRC §§ 170(o)(3)(A) (income tax); 2522(e)(3)(A) (gift tax) (as added by the Act). If the donee of the initial contribution is no longer in existence, the donor’s remaining interest may be contributed to another organization described in IRC § 170(c).

In any case in which there is a recapture of a deduction under the 10-year recapture rule, an additional tax equal to 10% of the amount recaptured is imposed. IRC § 170(o)(3)(B) (as added under the Act).

Thus, should the donor die within the 10-year period without the donee taking “substantial physical possession,” the statute appears to require recapture of the income and gift tax deductions even if the donor contributes all of the remaining interests in the property to the same donee organization at his death.

IRC §§ 170(o)(2) (income tax); 2055(g)(1) (estate tax); 2522(e)(2) (gift tax) (as added by the Act).

JCT Technical Explanation, p. 308.

In the press release, Senator Grassley stated: “Overvalued facade easements are pretty obvious. For example, it’s ridiculous for people in Georgetown to take tens of thousands of dollars in charitable tax deductions for agreeing not to put aluminum siding on their million-dollar house when local laws and regulations already prohibit such activity. Over the years, American communities have benefited from tax incentives that foster historic preservation. I want to continue the important goal of historic preservation while ending the abuse.”

Following these articles, the Senate Finance Committee held a hearing on June 8, 2005, entitled “The Tax Code and Land Conservation: Report on Investigations and Proposals for Reform.” At that time, the IRS had indicated that 240 donors were currently under audit regarding conservation easement donations and that the IRS had created a “cross-functional team” to look for various patterns of abuse in this area.

“Qualified organization” is defined at IRC § 170(h)(3).

IRC § 170(f)(15)(A) (as added by the Act).

Thus, if the value of contributed property claimed on a tax return is 150% (reduced from 200%) or more of the amount determined to be correct, a substantial valuation misstatement results under IRC 6662(e)(1). If the value of contributed property claimed on a tax return is 200% (reduced from 400%) or more of the amount determined to be correct, a gross valuation misstatement results under IRC 6662(h)(2).

IRC § 6659A(a)(1) (as added by the Act). Note that the penalty only applies for a substantial valuation misstatement occurs in the context of the income tax, given that the statute restricts the imposition of the penalty to a “substantial valuation misstatement under chapter 1.”

IRC § 6659A(b) (as added by the Act).

The Act itself does not impose minimum annual distribution requirements on donor advised funds or their sponsoring organizations, as had previously been proposed. See, e.g., S. 2020, which contained minimum distribution requirements applicable to both the sponsoring organization and each individual donor advised fund.
The Treasury Regulations governing these organizations are extremely lengthy and complex, to the point where one judge characterized these regulations as “fantastically intricate and detailed,” Windsor Foundation v. U.S., 77-2 U.S.T.C. ¶9709 (E.D. Va. 1977).

The term “sponsoring organization” means an organization that: (1) is described in IRC § 170(c) (other than a governmental entity and without regard to any requirement that the organization be organized in the United States); (2) is not a private foundation; and (3) maintains one or more donor advised funds. IRC § 4966(d)(1) (as added by the Act). Absent an organization being classified as a sponsoring organization, any fund maintained by the organization will not be considered a donor advised fund and will not, therefore, be subject to the new rules applicable to a donor advised fund. Thus, for example, a fund maintained by a private foundation over which a person, such as the grandchild of the founder, has advisory privileges would not be considered a donor advised fund given that a sponsoring organizations does not include a private foundation.

A reasonable expectation of advisory privileges exists if both the donor or an advisor to a fund and the sponsoring organization have reason to believe that the donor or advisor will provide advice and that the sponsoring organization will consider it. JCT Technical Explanation, p. 344. Where such reasonable expectation is due solely to the donor’s service to the sponsoring organization by reason, for example, of the donor’s position as an officer, employee or director of the organization, the third requirement for donor advised fund status will not be met. Id.

A fund may be treated as identified by reference to contributions of a donor or donors if the reference is to persons related to a donor. For example, if a husband makes contributions to a fund that is named after his wife, the fund is treated as being separately identified by reference to contributions of a donor. Id.

The Secretary has authority to look to the substance of the arrangement, and not merely its form, in making this determination. Id.

See, e.g., Pauley, 29 AFTR 2d 72-1025, 459 F2d 624 (CA-9, 1972) (“Dominion and control, the retention of which by a donor will render a gift incomplete for purposes of tax deduction, is dominion and control exercisable against the donee ...”); see also Burke, 61 AFTR 2d 88-1027 (DC Conn., 1988); Hansen, 60 AFTR 2d 87-5240 , 820 F2d 1464 (CA-9, 1987). For a further discussion of the tax implications relating to donor control issue, see Fox, “Planning for Donor Control and Other Strings Attached to Charitable Contributions,” 30 ETPL 441 (Sept. 2003). As discussed below, no charitable deduction is allowed, in any event, for a contribution to a donor advised fund unless the donor obtains a contemporaneous written acknowledgement from the sponsoring organization that such organization “has exclusive legal control over the assets contributed.”

As discussed below, no charitable deduction is allowed, in any event, for a contribution to a donor advised fund unless the donor obtains a contemporaneous written acknowledgement from the sponsoring organization that such organization “has exclusive legal control over the assets contributed.”

Id.
Id. Any legal right retained by a donor must be carefully scrutinized to assure that the retention of the right will not prevent a completed gift from occurring or cause the contribution to be treated as a nondeductible contribution of a partial interest. In cases where there is uncertainty regarding this issue and the gift is of a substantial magnitude, a private letter ruling should be considered before making the contribution. See, e.g., LTR 9303007, in which the IRS ruled that the retention of certain display rights with respect to contributed artwork were “not substantial in that they are largely fiduciary powers to be exercised in furtherance of the charitable purposes of the Donee.” See also Fox, “Planning for Donor Control and Other Strings Attached to Charitable Contributions,” 30 ETPL 441 (Sept. 2003).

See, e.g., Ltr. Rul. 7827105, in which the IRS ruled that a separate endowment fund established by the taxpayer at a university would not be treated as a separate taxpayer because it “will at all times be subject to the complete and exclusive control of M University and will be operated as an integral part of the charitable and educational activities of M University.” Where a donor retains a legal right to direct distributions from a fund maintained at a charity that is wholly dedicated to IRC § 170(c)(2) purposes, the likely result is that there would be a completed gift, but that the amounts held in the fund would be considered a separate private foundation. In such a case, the fund would be subject to the Chapter 42 excise tax rules, including the tax on net investment income under IRC § 4940 that would not otherwise apply to the fund. Moreover, the donor would be subject to the limitations of IRC § 170(e)(1)(B)(ii), generally limiting contributions of property (i.e., other than money) to a private foundation to income tax basis except for contributions of “qualified appreciated stock,” and the less favorable gross income limitations under IRC § 170(b) applicable to contributions to private foundations.

IRC § 4966(d)(2)(B)(i) (as added by the Act).

JCT Technical Explanation, p. 345.

IRC § 4966(d)(2)(B)(ii) (as added by the Act).

IRC § 4966(a)(1) (as added by the Act).

For this purpose, a “fund manager” is defined as an officer, director, or trustee of the sponsoring organization (or an individual having powers or responsibilities similar to those of officers, directors, or trustees of the sponsoring organization) and with respect to any act (or failure to act), the employees of the sponsoring organization having authority or responsibility with respect to such act (or failure to act). IRC § 4966(d)(3) (as added by the Act).

IRC § 4966(a)(2) and (b) (as added by the Act)

IRC § 4966(c)(1)(A) (as added by the Act). In a letter to the Department of Treasury dated August 16, 2006, the COF stated that “[w]hile we believe that ‘distribution’ was intended to refer to gratuitous transfers of money and property, we would appreciate clarification that a ‘distribution’ does not include payments made to third parties for the purchase of goods and services needed to carry out the exempt purposes of a donor-advised fund and that the rule prohibiting distributions to individuals does not apply to the purchase of goods and services.”

See IRC § 4941(d)(2)(E), allowing for the payment of compensation (and the payment or reimbursement of expenses) for personal services which are reasonable and necessary in carrying out the exempt purposes of the private foundation.
The purposes enumerated under IRC § 170(c)(2)(B) includes religious, charitable, scientific, literary, and educational, purposes also enumerated under IRC § 501(c)(3).

IRC § 4966(c)(1)(B) (as added by the Act). Thus, for example, a distribution made to a noncharitable organization, or to a charitable organization not described in IRC § 170(b)(1)(A), exclusively for one or more IRC § 170(c)(2)(B) purposes would not constitute a taxable distribution if the sponsoring organization exercises expenditure responsibility. Generally, “expenditure responsibility” involves exerting all reasonable efforts and to establish adequate procedures: (i) to see that the grant is spent solely for the purpose for which it is made; (ii) to obtain full and complete reports from the grantee on how the funds are spent; and (iii) to make full and detailed reports to the IRS with respect to the expenditure of such funds. Detailed rules regarding “expenditure responsibility” are set forth in Reg. § 53.4945-5(a)(6)(i).

IRC § 4966(c)(2) (as added by the Act).

An equivalency determination requires that a good faith determination is made regarding the status of a foreign charity under U.S. tax laws based upon either an affidavit of the foreign charity or an opinion of counsel. Reg. § §53.4942(a)-3(a)(6) and 53.4945-5(a)(5).

For a further discussion of expenditure responsibility in the context of a grant to a foreign charity, see Fox, “Planning for Contributions to Foreign Charities by Individuals and Foundations,” 32 ETPL 18 (July. 2005).

IRC § 170(b)(1)(A)(viii) includes an organization described in IRC § 509(a)(3), the section of the Internal Revenue Code describing supporting organizations.

IRC § 4966(c)(2)(A). The determination of whether a Type III supporting organization is a functionally integrated Type III organization is discussed below under “Change in Classification Rules for Type III Supporting Organization Status.”

Such a policy could include, for example, obtaining representations from a prospective donee Type III supporting organization that it is “functionally integrated” and obtaining representations that a prospective donee supporting organization is not directly or indirectly controlled by the donor, the advisor to the fund, or any persons related to the donor or the advisor.

Family members and 35% controlled entities, which are defined under IRC § 4948(f), as amended by Section 1232 of the Act, are hereinafter referred to collectively as “related parties.” IRC § 4958(f)(4) defines members of an individual’s family by reference to IRC § 4946(d) (spouse, ancestors, children, grandchildren, great grandchildren, and the spouses of children, grandchildren and great grandchildren), except such family members also include brothers and sisters of the individual and their spouses. 35% controlled entities include a corporation, partnership and a trust or estate in which, respectively, more than the 35% of the combined voting power, profits interest, and beneficial interests are owned.
IRC § 4967(a)(1) and (c)(1) (as added by the Act).

IRC § 4967(a)(2) and (c)(2) (as added by the Act).

Thus, for example, a benefit considered a “token benefit” under the safe harbor rules under Rev. Proc. 90-12, 1990-1 C.B. 471, will not be treated as having a more than incidental benefit because such a benefit is disregarded under IRC § 170.

Note that the excise tax under IRC § 4967 is not imposed, however, on a distribution if a tax is imposed under the excess benefit transaction rules of IRC § 4958, discussed below, thereby precluding the imposition of a double tax on such distribution. IRC § 4967(b) (as added by the Act).

See Ltr. Rul. 8449008 (no act of self-dealing or taxable expenditure occurs where a private foundation pays the full purchase price of a fund-raising ticket to an event sponsored by an organization the foundation normally supports where the person using the ticket is an officer, direct or employee of the foundation and the attendance of the event relates to such person’s official capacity within the foundation).

Note that this “automatic excess benefit” only applies where the payment of a grant, loan, compensation or similar payment is properly viewed as a payment from a donor advised fund and not from the sponsoring organization. For example, if a sponsoring organization pays compensation to a service provider who also is a donor to a donor advised fund, such payment will be considered as a payment from the sponsoring organization, not from the donor advised fund. See JCT Technical Explanation, p. 348.

IRC § 4958(c)(2)(B) (as added by the Act). This is contrary to the general rule under IRC § 4958, where an “excess benefit” is only considered to occur where the economic benefit provided by an IRC § 501(c)(3) organization to a disqualified person exceeds the value of the consideration received in return from the disqualified person.

The person receiving the benefit is subject to the first tier tax of 25% and, if the benefit involved is not “corrected,” a second tier tax of 200%. IRC § 4958(a)(1) and (b). The organization manager participating in the excess benefit transaction is subject to a first tier tax of 10%, but only if such person had knowledge that an excess benefit transaction was involved. In addition, the organization manager will not be subject to such tax if his participation “is not willful and is due to reasonable cause.” IRC § 4958(a)(2).

JCT Technical Explanation, p. 347.

The general rule is that such compensation is an act of self-dealing under IRC § 4941(d)(1)(D), but there is an exception provided under IRC § 4941(d)(2)(E) for the payment of compensation (and the payment or reimbursement of expenses) for personal services which are reasonable and necessary in carrying out the exempt purposes of the private foundation. For this purposes, “personal services” is generally narrowly construed, however. See John Madden Jr. v. Commissioner, T.C. Memo 1997-395, where the Tax Court noted that “any exceptions to the self-dealing transaction rules should be construed narrowly.” In that case, the court held that the provision of general maintenance, janitorial services and custodial services to a private foundation museum by a disqualified person did not constitute personal services within the meaning of IRC § 4941(d)(2)(E).
IRC § 4958(f)(7) (as added by the Act), adding such individuals to the category of disqualified persons under IRC § 4958(f)(1). Donors, advisors and their related parties are disqualified persons with respect to a donor advised fund and investment advisors and their related parties are disqualified persons with respect to the sponsoring organization. Prior to the Act, such persons would not be considered disqualified persons unless they were in “a position to exercise substantial influence over the affairs of the [sponsoring] organization,” which typically is not the case.

IRC § 4958(c)(1)(A).

The “excess business holdings” rule of IRC § 4943 was enacted as part of the Tax Reform Act of 1969 in order to address the concerns of Congress regarding the number of private foundations being used at that time to maintain control of business interests, rather than furthering charitable purposes.

A “business enterprise” generally includes the active conduct of a trade or business that does not relate to carrying out a charitable purpose, whether conducted by a corporation, a partnership or a sole proprietorship. See IRC §4943(d)(3)(A). A business which derives more than 95% of its gross income from “passive sources” does not constitute a “business enterprise” within the meaning of IRC § 4943 and an investment in such an entity will not constitute a “business holding.” IRC § 4943(d)(3)(B). Gross income from passive sources generally includes dividends, interest, payments with respect to securities loans, royalties, rents and gains from the sale, exchange or disposition of property other than inventory or stock in trade. Under IRC § 4943(d)(3), passive source income also includes income from the sale of goods if the seller does not manufacture, produce, physically receive or deliver, negotiate the sale of, or maintain inventories in such goods.

IRC § 4943(c)(2)(A). Under a limited exception, the 20% is replaced by 35% where “effective control of the corporation is in one or more persons who are not disqualified persons with respect to the foundation.” IRC § 4943(c)(2)(B). In all cases, however, under the de minimis rule of IRC § 4943(c)(2)(C), a donor advised fund will not be treated as having excess business holdings in any corporation in which it owns not more than 2% of the voting stock and not more than 2% in value of all classes of stock, regardless of the stock holdings of disqualified persons. IRC § 4943(c)(2)(A).

IRC § 4943(c)(2)(A).

The violation of the excess business holdings rule of IRC § 4943 results in an initial excise tax equal to 10% of the value of the “excess business holdings” for each taxable year for which such holdings exists, followed by a 200% tax of such excess holdings if the violation is not corrected within a stated period of time. IRC § 4943(a)(1) (10% initial tax) and Section 4943(b) (200% additional tax).

IRC § 4943(e)(2) (as added by the Act).

IRC § 4943(c)(6) (general 5-year rule); 4943(d)(7) (additional 5-year period).

IRC § 4943(e)(3) (as added by the Act).
IRC §§ 170(f)(18) (income tax), 2055(e)(5) (estate tax), and 2522(c)(5) (gift tax) (as added by the Act), all effective for contributions made after the date which is 180 days after August 17, 2006, or February 13, 2007.

Indeed, the new acknowledgement provisions regarding the sponsoring organization’s “exclusive control” specifically provide that rules similar to IRC § 170(f)(8) shall apply. Thus, the donor must obtain the newly required acknowledgment for contributions to donor advised funds on or before the earlier of the date on which the taxpayer files a tax return for the taxable year in which the contribution was made or the due date, including extensions, for filing such return. IRC § 170(f)(8)(C). Like the rules under IRC § 170(f)(8), it is the donor’s obligation to obtain the new acknowledgment regarding the “exclusive legal control,” although sponsoring organizations clearly should comply with this provision to ensure that their donors are not denied a charitable deduction.

The determination of whether a Type III supporting organization is a functionally integrated Type III organization is discussed below under “Change in Classification Rules for Type III Supporting Organization Status.” Note that a charitable deduction is also denied if the sponsoring organization is described in IRC § 170(c)(3), (4) or (5).

Prior to this amendment, the relationship test under IRC § 509(a)(3)(B) provided that the supporting organization be “operated, supervised, or controlled by or in connection with one or more” supported organizations.

Reg. § 1.509(a)-4(f)(2).

IRC § 509(a)(3)(B)(i) (as added by the Act) (this relationship is generally comparable to a parent-subsidiary relationship).

IRC § 509(a)(3)(B)(ii) (as added by the Act) (this relationship generally requires that a majority of the supporting organization’s governing board be on the board of the supported organization).

IRC § 509(a)(3)(B)(iii) (as added by the Act) (this relationship has the least connection between the supporting organization and the supported organization, which requires that a “relationship” and “integral part” test of the regulations be met). Type III supporting organizations, including changes made under the Act applicable to such organizations, are discussed further below.

IRC § 509(f)(2)(A) (as added by the Act). “Direct or indirect control” is not defined under the Act. Under pre-Act supporting organization jurisprudence, control means that disqualified persons, by aggregating their votes or positions of authority, may require such organization to perform any act which significantly affects its operations or may prevent such organization from performing such act. Reg. § 1.509(a)-4(j)(1). The sufficient voting power for this purpose is 50% percent or more of the total voting power of the organization’s governing body. Id. See also Rev. Rul. 80-207, 1980-2 C.B. 193, holding that where a disqualified person and two of his employees (who were not otherwise disqualified persons) constituted three of the four trustees of an organization, the organization could not qualify under IRC § 509(a)(3). The IRS stated that “[s]ince the organization is controlled by a disqualified person and the employees of a disqualified person …. it is not a supporting organization within the meaning of Section 509(a)(3). In its analysis, the IRS further stated: “[I]n determining whether an organization is indirectly controlled by one or more disqualified persons, one circumstance to be considered is whether a disqualified person is in a position to influence the decisions of members of the organization’s governing body who are not themselves disqualified persons. Thus, employees of a disqualified person will be considered in determining whether one or more disqualified persons controls 50 percent or more of the voting power of an organization’s governing body.”
The JCT Technical Explanation, p. 361, provides that “it is intended that indirect control includes the ability to exercise effective control. For example, if a person made a gift to a supporting organization and a combination of such person, a person related to such person, and such person’s personal attorney were members of the five-member board of a supported organization of the supporting organization, the organization would be treated as being indirectly controlled by such person. Board membership alone does not establish direct or indirect control.”

152 Thus, for example, other than for contributions of qualified appreciated securities, deductions for contributions of appreciated property to the organization would be subject to the basis limitation imposed under IRC § 170(e)(B)(ii) for contributions to private foundations. Also, all of the excise tax provisions applicable to private foundations, including the 5% minimum distribution requirement under IRC § 4942, the self-dealing rules under IRC § 4941, and the excess business holdings rule of IRC § 4943 would be applicable to the organization.

153 Reg. § 1.509(a)-4(i)(1)(i).

154 Reg. § 1.509(a)-4(i)(2)(ii).

155 Reg. § 1.509(a)-4(i)(2)(iii).

156 Treas. Reg. §1.509(a)-4(i)(3).

157 The term “income” is not defined; however, the IRS privately ruled that the term “adjusted net income” under Section 4942(f)(1) should be used as the definition of “income” for purposes of Reg. § 1.509(a)-4(i)(3)(iii)(a). See e.g., Ltr. Rul. 200045033 and TAM 9730002. Section 4942(f)(1) defines “adjusted net income” as the excess of the gross income for the taxable year, with certain modifications, including taking capital gains and losses into account only in an amount equal to any net short-term capital gain for the taxable year, over the sum of the deductions (with certain modifications) which would be allowed to a corporation subject to tax under Section 11 for the taxable year. Thus, while long-term capital gain is excluded from the definition of adjusted net income, net short-term capital gain is included in the definition of adjusted net income. See also Ltr. Rul. 9714006 (ruling that the net short-term capital gain is included in income for purposes of Reg. § 1.509(a)-4(i)(3)(iii)).

158 IRC § 4943(f)(5)(B) (as added by the Act).

159 Although IRC § 509(f)(1) provides that an organization will not be considered to be “operated in connection with” a supported organization unless it meets the new responsiveness requirement of IRC § 509(f)(1)(A), the JCT Technical Explanation indicates that “it is intended that failure to make a sufficient showing is a factor in determining whether the responsiveness test of present law is met.”

160 IRC § 509(f)(1)(B)(i). Under a transitional rule provided by IRC § 509(f)(1)(B)(ii), a Type III supporting organization currently operated in connection with a foreign charity may continue such status until the first day of the third taxable year of the organization beginning after the date of the enactment of the Act.

161 A “substantial contributor” is generally defined as someone who contributes at least $5,000 and more than 2% of the total contributions and bequests received. See IRC § 4958(c)(3)(C)(i).
IRC §4958(c)(3)(A)(i)(I) (as Added by the Act). Under this new rule, for example, the spouse of a major donor to a foundation formed as a supporting organization for a hospital or museum may not be allowed to serve as a paid employee.

IRC §4958(c)(3)(A)(i)(II) (as Added by the Act).

IRC § 4943(f)(3)(A) (as added by the Act).

IRC § 4943(f)(3)(B) (as added by the Act)

IRC § 4943(f)(4) (as added by the Act). A “disqualified person” does not include a public charity (other than a supporting organization).

IRC § 6033(a)(3)(B) (as amended by the Act).

IRC § 6033(l)(2) (as added by the Act).

IRC § 6033(l)(3) (as added by the Act). The JCT Technical Explanation, p. 359, states that “it is intended that supporting organizations be able to certify that the majority of the organization’s governing body is comprised of individuals who were selected based on their special knowledge or expertise in the particular field or discipline in which the supporting organization is operating, or because they represent the particular community that is served by the supported public charities.”

The initial tax on the self-dealer is increased from 5% of the amount involved to 10%. Similarly, the initial tax on foundation managers is increased from 2.5% of the amount involved to 5%. The additional taxes imposed on the self-dealer and the foundation manager remain at 200% and 50%, respectively. The dollar limitation on the amount of the initial and additional taxes on foundation managers per act of self-dealing is increased from $10,000 per act to $20,000 per act.

The initial tax on the private foundation is increased from 15% to 30% on the amount of the shortfall with respect to the 5% minimum distribution requirement. The additional tax remains at 100%.

The initial tax on excess business holdings is increased from 5% of the value of such holdings to 10%. The additional tax remains at 200%.

The initial tax on the amount of the jeopardy investment that is imposed on the foundation and the foundation manager is increased from 5% to 10%. The additional tax imposed on the foundation and the foundation manager remains at 25% and 5%. The dollar limitation on the initial tax on foundation manager is increased from $5,000 to $10,000 and from $10,000 to $20,000 for the additional tax.

The initial tax on the foundation is increased from 10% of the amount of the taxable expenditure to 20% and is increased from 2 1/2% to 5% for the foundation manager. The additional tax imposed on the foundation and the
foundation manager remains at 100% and 50%. The dollar limitation on the foundation manager is increased from $5,000 to $10,000 for the initial tax and from $10,000 to $20,000 for the additional tax.

175 IRC § 4942(g)(4)(A)(i) (as added by the Act).

176 IRC § 4945(d)(4)(A)(ii) (as added by the Act); see also IRC § 4942(g)(4)(A).

177 Id.

178 IRC § 4942(g)(4)(A)(ii) (as added by the Act).

179 IRC § 4945(d)(4)(A)(ii) (as added by the Act).

180 687 F. 2d 97 (5th Cir. 1982); see JCT Technical Explanation, p. 322.

181 JCT Technical Explanation, p.

182 IRC § 4940(c)(4) (including capital gain income from the disposition of property “used for the production of gross income,” rather than the pre-Act language of “used for the production of interest, dividends, rents and royalties”).