

**OVERVIEW OF NEW LEGISLATION AFFECTING CHARITABLE ORGANIZATIONS
CONTAINED IN THE PENSION PROTECTION ACT OF 2006 (H.R. 4)**

On August 17, 2006, President Bush signed into law the Pension Protection Act of 2006 (H.R. 4) (the "Act"). The Act contains a number of provisions affecting charitable organizations and their donors, many of which are effective immediately. We have prepared the following summary of certain relevant provisions in order to help you evaluate how your organization will be affected by the new law. **This is not a complete summary of the Act as it relates to charitable organizations, and this information should not be considered a substitute for specific legal advice.** If you have any questions about the application of the new law to your organization, please contact us directly.

Unless otherwise noted, all provisions discussed below are effective as of the date of enactment.

I. Changes in Deductibility of Certain Charitable Donations

Although the changes listed in this section are most directly applicable to the donors, rather than the charitable organization, charities need to be aware of these new rules in order to properly advise their donors and to assist them in meeting the new substantiation requirements.

1. In order for a donor to receive a tax deduction for a charitable donation, the donor must now provide substantiation for any contribution, regardless of the amount.

Donors who itemize their deductions on their income tax returns are permitted to deduct, within certain limitations, the amount of cash and the fair market value of property contributed to a charitable organization. Previously, in the case of cash contributions, substantiation of these deductions, in the form of an acknowledgment of the contribution by the donee organization, was only required for contributions of \$250 or more. Under the new law, substantiation is required for any deduction taken for a charitable contribution of cash, regardless of the amount. The substantiation must take the form of a written communication from the donee, indicating the name of the donee organization and the date and amount of the contribution. Even though the charity by law is still only required to provide a written acknowledgment when it receives a donation of \$75 or more, made in exchange for goods or services provided by the charity, it is good practice, in light of the heightened donor requirements, for your organization to implement a system of acknowledging every contribution.

This provision is effective for contributions made in taxable years beginning after the date of enactment.

2. Any tax deductions permitted for donated tangible personal property may be recaptured if the property is not used for an exempt purpose.

In general, donors donating to a public charity or a private operating foundation non-cash property that has appreciated in value during the donor's possession may take a deduction equal to the fair market value of the contributed property. However, if the donated property is personal tangible property that the organization uses in a manner unrelated to its exempt purpose, the deduction is limited to the donor's basis in the donated property. If the donor is claiming a deduction in excess of \$500 for the contribution, s/he must attach to the return a completed I.R.S. Form 8283 (Noncash Charitable Contributions), which, among other information, requires the donee to indicate whether the property is intended for an unrelated use.

The provision of the Act requiring the recapture of the deduction for property not used for an exempt purpose applies to property that has been identified by the donee organization on the Form 8283 as intended for a related use and for which a deduction of more than \$5,000 is claimed. Under the provision, if a donee organization disposes of such property within three years of its contribution, the donor is subject to an adjustment of the tax benefit. If the disposition occurs in the same year in which the contribution is made, the donor can only claim a deduction equal to his or her basis in the property. If the disposition occurs in the next year or two, the donor must include as ordinary income for that taxable year the excess of the deduction previously taken over the donor's basis in the property at the time of the contribution.

The law does provide an exception in cases in which the subject property is no longer used for an exempt purpose because such use became impossible or infeasible to implement. In order to apply for the exception, the donee organization must certify to the IRS in a written statement that the property had been used by the donee organization for an exempt purpose, describe that use, and state that such continued use has become impossible or infeasible.

Any person who intentionally misrepresents applicable property as having a related use is subject to a \$10,000 fine.

3. No deduction is permitted for a charitable contribution of clothing or household items unless the clothing or household items are in good condition.

The rule described above concerning the relationship between exempt use and the deduction permitted for charitable contributions of property applies generally to non-cash donations that have appreciated in value during the donor's ownership of the property. If a donor contributes clothing or household items that have appreciated in value during the donor's ownership, the rule described above will apply. However, most donations of clothing or household items are of items that have depreciated, not increased in value, during the donor's ownership. According to the IRS rules governing donations of depreciated property, donors of such items may only deduct the fair market value of the items at the time of the contribution (a lesser deduction, in these cases, than basis). As a result, donors of clothing or household items will generally deduct the fair market value of the items they contribute, regardless of whether such items are used by the donee organization for exempt or unrelated purposes.

The Act provides that only donors contributing clothing or household items in good condition or better may take any deduction, basis or fair market value. The Act does provide an exception for items not in good condition if the amount claimed for the item is more than \$500 and the donor attaches a qualified appraisal with respect to the property to his or her tax return. Furniture, furnishings, electronics and appliances are considered household items for the purpose of the new rule; food, paintings and other art objects, gemstones, jewelry and collections are not.

4. The Act narrows the deductions permitted for donations of partial interest in tangible personal property.

The Act also tightens the rules governing deductions allowed for donations of partial interests in tangible personal property. The deduction for the initial contribution of a fractional interest will continue to be based on the fair market value of the item at the time of the donation (provided the item is being donated for an exempt purpose), but all deductions based on subsequent contributions will be determined based upon the lesser of the fair market value of the item at the time of the initial contribution or at the time of each subsequent contribution. The new rules also require that charities receiving a fractional interest in an item of tangible personal property must take complete ownership of the item within ten years or the death of the donor, whichever is earlier. Additionally, the donee must take possession of the item at least once during the ten-year period and use it for the organization's exempt purpose. If either of these requirements are not met, any deductions allowed, plus interest thereon, shall be recaptured and a tax equal to the 10% of the recaptured amount will be imposed.

Contributions occurring before the date of enactment will not be treated as an initial fractional contribution for the purposes of the provision; instead, the first fractional contribution by a taxpayer after the date of enactment will be considered the initial fractional contribution under the provision.

5. For a limited time, up to \$100,000 in tax-free distributions from individual retirement plans are permitted per taxable year.

While the Act for the most part imposes increased restrictions on the operation of charitable organizations and charitable giving, the Act's most publicized change is this provision designed to stimulate charitable giving. The Act provides that through 2007, individuals who are 70 ½ or older may exclude from income up to \$100,000 annually in qualified charitable distributions from a traditional or Roth IRA. Such qualified charitable distributions will be taken into account for purposes of the minimum distribution rules applicable to traditional IRAs, but not in determining whether a donor has reached the applicable percentage limit of his or her contribution base.

Distributions to a donor advised fund, a supporting organization or a private non-operating foundation do not qualify for the income exclusion.

II. Changes in Reporting and Disclosure Requirements

The Act also contains a number of provisions increasing the public disclosure required of charitable organizations.

6. Charitable organizations must make the unrelated business income tax return on Form 990-T available for public inspection.

Under current law, charitable and social welfare organizations and civic leagues are required to make copies of their annual information returns on Form 990 and copies of their exemption materials publicly available. A fine of \$20 per day is applied, up to a limit of \$10,000 in the case of a single return, for failure to comply with the public disclosure requirements (there is no limitation on the penalty for failure to make exemption materials publicly available). If the failure to comply is willful, an additional penalty of \$5,000 is sanctioned.

Under the Act, the regulations governing public disclosure of annual informational returns is extended to the unrelated business income tax return on Form 990-T. Certain information may be withheld upon application to the IRS if it is determined that the disclosure of such information would adversely affect the organization.

7. Organizations excused from filing an annual information return on IRS Form 990 by reason of having gross receipts below \$25,000 a year must file notice with the IRS on an annual basis.

Generally, charitable organizations (other than private foundations) with gross receipts below \$25,000 are not required to furnish the IRS with an annual information return on IRS Form 990. Under the previous rules, in fact, such organizations did not have any reporting obligations whatsoever to the IRS once they received their final determinations letter and in the absence of any material changes. Under the new rules, these organizations (with the exception of supporting organizations, as discussed immediately below) must now file on an annual basis with the IRS written notice, in electronic format, listing the name of the organization, any name under which it operates or does business, its mail and internet website address, if any, its taxpayer identification number, the name and address of a principal officer and evidence of the organization's continuing basis for its exemption from the regular reporting requirements. Notice must also be furnished upon the termination of the organization's existence.

The IRS will also revoke the tax-exempt status of any organization that fails to file the Form 990 or the required notice, as applicable, for three consecutive years. Any organization which has its status revoked must apply again for recognition of tax-exempt status.

The new notice requirements go into effect in 2007.

8. All supporting organizations, regardless of gross receipts, must file an information return on Form 990.

Supporting organizations are held under the Act to a higher threshold of accountability and transparency than other public charities. Whereas, as described above, most public charities with gross receipts below \$25,000 are now required to file an annual notice with the IRS, all supporting organizations will now be required to submit information returns on Form 990 each year, regardless of the amount of gross receipts. The Form 990 will also call for increased disclosure by supporting organizations: a supporting organization will have to indicate whether it is a Type I, Type II or Type III supporting organization, identify its supported organization, and certify that it is not controlled directly or indirectly by one or more disqualified persons (other than foundation managers and publicly supported organizations). The Joint Committee on Taxation, in its published summary of the Act (the “Joint Committee Summary”), explains that a supporting organization should be able to demonstrate that the majority of its governing body is comprised of individuals selected based upon special knowledge or expertise in the field in which the supporting organization is operating, or because they represent the particular community that is served by the supported public charities.

III. Changes Specific to Supporting Organizations

Supporting organizations have recently been the subject of much scrutiny in Congress, reflecting lawmakers’ concerns that some donors are misusing supporting organizations as personal investment vehicles.¹ Accordingly, in addition to the increased disclosure obligations described in paragraph 8, above, the Act also contains a number of anti-abuse rules governing their operation, expanding the scope of the excess benefit excise tax and extending to certain types of supporting organizations a number of the restrictions imposed on private foundations. These changes are described below.

9. Grants, loans, compensation and similar payments made by a supporting organization to substantial contributor, as well as loans to a disqualified person, are automatically treated as excess benefit transactions, and the entire amount of the payment is deemed to be an excess benefit.

The Code imposes excise taxes on excess benefit transactions between disqualified persons and all public charities. Under these rules, known as intermediate sanctions, if, in a transaction between a disqualified person and a public charity, an economic benefit is provided to the disqualified person that exceeds the value of the consideration, the excess must 1) be refunded to the organization and 2) the disqualified person and, if appropriate, the organization manager(s) responsible for approving the transaction, will be fined a percentage of the amount by which the disqualified person improperly benefited.

¹ One concern is that donors are taking deductions for contributions to supporting organizations which pay out few funds to the charities they ostensibly support, and which at the same time, are used to provide benefits (such as loans, a practice which is prohibited in NY as a matter of state law, and reimbursement of expenses) to the donors or related parties.

Under the new rules, the definition of an excess benefit transaction is expanded for supporting organizations, so that intermediate sanctions may be imposed if a supporting organization makes a grant, loan, payment of compensation or similar payment to a substantial contributor, or a related person, of the supporting organization.² A substantial contributor is any person who contributed or bequeathed more than \$5,000 in a given taxable year, if such amount is more than two percent of the total contributions and bequests received by the organization before the close of that year. In the case of a charitable trust, the creator of the trust is also considered a substantial contributor. Public charities, other than another supporting organization, are excluded from the definition of substantial contributor. A person is a related person of a substantial contributor if such person is a family member of the substantial contributor or is an entity of which the substantial contributor or any family member thereof owns or controls more than 35%. The entirety of the prohibited payment is subject to the excise tax.

Additionally, any loan by a supporting organization to a disqualified person is deemed in its entirety an excess benefit, and the excise tax is again imposed on the full amount of the payment. (In New York, of course, loans are already prohibited as a matter of law.) Public charities, other than another supporting organization, are also excluded from the definition of disqualified person for this purpose.

These rules apply retroactively to transactions occurring after July 25, 2006.

10. Type III supporting organizations, other than functionally integrated Type III supporting organizations, will be required to make certain minimum payouts to the supported charities.

Type III supporting organizations are organizations that receive their public charity status because they are “operated in connection with” one or more publicly supported organizations. In order to claim this classification, the organization must meet two tests, identified in the regulations as the “responsiveness test” and the “integral part test”. According to the integral part test, organizations may be deemed to be an integral part of a public charity if: 1) the activities engaged in by the supporting organizations are activities to perform the functions of, or carry out the purposes of, the supported organization, and these activities, but for the involvement of the supporting organization, would be carried out by the supported organization itself; *or* 2) the organization pays substantially all of its income to or for the use of one or more publicly supported organizations, which organization(s), by virtue of this support, is attentive to the operations of the supporting organization. Supporting organizations that satisfy the integral part test by meeting the first criteria are deemed to be “functionally integrated” Type III supporting organizations.

The lawmakers are more concerned with the potential for abuse of Type III supporting organizations that satisfy the integral part test by paying out income to one or more public charities. Accordingly, the Act directs the Secretary of the Treasury to promulgate new regulations on payments that will be required of such organizations. These regulations, which

² Similar payments do not include payments pursuant to bona fide sales or leases. These transactions are subject to the generally applicable excess benefit rules if the substantial contributor meets the definition of a disqualified person.

have not yet been issued, will require these organizations to distribute a percentage of either their income or their assets to the public charities they support.

11. The excess business holdings rules currently applied to private foundations are extended to Type III supporting organizations, other than functionally integrated Type III supporting organizations, and certain Type II supporting organizations.

Under the excess business holding rules previously applicable only to private foundations, a foundation is permitted to hold 20% of the voting stock of a corporation, less the amount of voting stock held by all disqualified persons of the foundation, and, if no disqualified person has effective control of the corporation, a private foundation and disqualified persons may together own up to 35% of the voting stock of a corporation. The Act has extended this restriction to Type III supporting organizations, other than functionally integrated Type III supporting organizations, as well as Type II supporting organizations if such an organization accepts a gift or contribution from 1) a person, or family member of such person, who controls, directly or indirectly, the governing body of a supported organization, or 2) an entity 35% controlled by such person. Covered organizations that violate these rules must dispose of the excess holdings and are subject to a tax.

The Act provides for transition rules that apply to any excess holdings of a covered supporting organization as of the present taxable year, and grants the Secretary authority not to impose these rules if an organization establishes that the excess holdings are consistent with the organization's exempt purpose or function.

12. A Type III supporting organization is required to keep any supported organization(s) sufficiently informed of its operations so as to ensure the supported organization's responsiveness.

As discussed in paragraph 10 above, organizations seeking classification as a Type III supporting organization must satisfy two tests, the responsiveness test and the integral part test. As another safeguard against abuse, the Act requires that Type III supporting organizations provide to the supported organizations such information regarding the supporting organization as is appropriate to ensure the supporting organization's responsiveness.

The Joint Committee Summary indicates that the necessary disclosure will generally be satisfied by the provision of such documents as the supporting organization's governing documents, annual information returns and tax returns, and annual reports that detail the support provided by the supporting organization and include a projection of the anticipated support for the next year. The provision of this documentation will be a factor in determining whether the responsiveness test is met.

13. Type I and Type III supporting organizations are prohibited from accepting certain contributions.

Type I and Type III supporting organizations may not accept gifts or contributions from a person (other than a 509(a)(1) or 509(a)(2) public charity), or a family member thereof, who controls,

directly or indirectly, the governing body of a supported organization of the supporting organization, or from a 35% controlled entity of such person. If the supporting organization violates this prohibition, it will lose its public charity status and be treated as a private foundation until such time as it may be able to demonstrate that it qualifies as a public charity *other than* a supporting organization.

14. Type III supporting organizations may not support foreign organizations.

The Act provides that no Type III supporting organization may support an organization organized outside of the United States. For Type III supporting organizations supporting a foreign organization on the date of the Act's enactment, the rule will not go into effect until the third taxable year after the date of enactment.

15. A Treasury study is directed to examine the organization and operation of supporting organizations.

The Act directs the Secretary of the Treasury to undertake a study of the organization and operation of supporting organizations and donor-advised funds, with the goal of determining if such organizations in general are operating in a manner consistent with the purposes constituting the basis for their tax-exempt status and whether the availability of charitable deductions allowed for contributions to such organizations is appropriate.

A report on the study will be submitted within one year of the Act's enactment, and will contain recommendations for further action.

IV. Changes Specific to Private Foundations

The Act also increases certain taxes imposed on private foundations.

16. The definition of gross investment income is expanded, including for the purposes of calculating the 2% excise tax imposed on net investment income.

The Act amends the definition of gross investment income to include income from "sources similar" those enumerated in Section 4940 of the Code, overriding case law that has interpreted the definition as limited to those items explicitly enumerated therein. Gross investment income will now include income from investments such as notional principal contracts, annuities, and, with respect to capital gain net income, capital gains from appreciation, including capital gains from the sale or other disposition of assets used to further an exempt purpose. An exception applies with respect to any portion of property used for at least one year for a purpose or function constituting the basis of the foundation's exemption, provided that such property is exchanged immediately for property of like kind to be used for an exempt purpose.

The provision is effective for taxable years beginning after the date of enactment.

17. The excise taxes imposed on private foundations for self-dealing, failure to distribute income, excess business holdings, jeopardizing investments and taxable expenditures are increased.

The Act doubles a number of the penalties applicable to these prohibited transactions, as follows:

- Self-dealing transactions:
 - Self-dealer: initial tax increased from 5% of the amount involved to 10%
 - Foundation managers: initial tax increased from 2.5% to 5% and the dollar limitation per act is increased from \$10,000 to \$20,000.
- Failure to distribute income:
 - Initial tax on the foundation is increased from 15% to 30% of the undistributed amount.
- Excess business holdings:
 - Initial tax on the foundation is increased from 5% to 10% of the value of the holdings.
- Jeopardizing investments:
 - Initial tax on foundation and foundation managers is increased from 5% to 10% of the amount of the investment.
 - Dollar limitation on the foundation manager tax is increased from \$5,000 to \$10,000 for the initial tax and from \$10,000 to \$20,000 for the additional tax.
- Taxable expenditures:
 - Initial tax on foundation and foundation managers is increased from 10% to 20% and from 2.5% to 5%, respectively, of the amount of the expenditure.
 - The dollar limitation on the foundation manager tax is increased from \$5,000 to \$10,000 for the initial tax and from \$10,000 to \$20,000 for the additional tax.

The provision is effective for taxable years beginning after the date of enactment.

18. Qualifying distributions are limited.

A private foundation may not count as a qualifying distribution any amount paid to a Type III supporting organization that is not a functionally integrated Type III supporting organization, or to any other supporting organization if a disqualified person with respect to the foundation directly or indirectly controls the supporting organization or one of its supported organizations. Any such payment will be treated as a taxable expenditure.

V. Other Provisions of Interest

19. The Act broadens the scope and penalty of self-dealing transactions involving public charities and social welfare organizations.

Under the Act, a disqualified person of a supporting organization is now treated as a disqualified person of the supported organization. Additionally, the Act doubles the dollar limitation for self-dealing excise taxes imposed on organization managers of public charities and social welfare

organizations. Organization managers who participate in excess benefit transactions may now be fined up to \$20,000 per transaction, rather than \$10,000 as under previous law.

20. Tax treatment of certain payments by taxable subsidiaries to controlling exempt organizations modified.

Prior to the enactment of the Act, rent, royalty, annuity and interest income paid to a tax-exempt organization by a controlled taxable subsidiary was treated as unrelated business income of the exempt parent organization. The Act changes the tax treatment of all such payments that are received or accrued between December 31, 2005 and January 1, 2008 pursuant to a binding written contract in effect on the date of enactment. The Act provides that only the portion of payments received in a taxable year that exceeds fair market value is included in the parent organization's unrelated business income. Additionally, a 20% penalty will be assessed on this amount.

All exempt organizations that receive interest, rent, annuity or royalty payments from a controlled entity must report these payments, as well as any loans made to the controlled entity and any transfers between the two, on its annual information return.

*If you have any questions or would like more information, please contact
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