

THE PENSION PROTECTION ACT OF 2006

SUMMARY OF CHARITABLE PROVISIONS



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Summary of the Charitable Provisions in the Pension Protection Act of 2006

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Charitable IRA Rollover

Under current law, a distribution from an IRA to a charity was included in the gross income of the owner of the IRA. For tax years 2006 and 2007, each taxpayer may rollover up to \$100,000 per year from their IRA to a qualified charity without including the rollover amount in gross income. A *qualified charitable distribution* must satisfy all of the following:

- The donor must be age 70 ½ on or before the date of the rollover;
- The charity must be a public charity but not a donor-advised fund or supporting organization;
- The distribution must be a direct trustee-to-charity transfer;
- The entire distribution must qualify as a deductible contribution were it not for this provision;
- The exclusion from gross income only applies to distribution

amounts that would be includible in gross income were it not for this provision; and

- Rollovers from SEPs and SIMPLEs do not qualify.

Planning Pointer:

Only distributions from a taxpayer's own IRA are includible in determining that a taxpayer has met the \$100,000 limit. Therefore, while married taxpayers may make qualified distributions totaling \$200,000, each spouse must make distributions of up to \$100,000 from their own IRA.

Qualified charitable distributions are taken into account for purposes of the minimum distribution rules.

No charitable deduction is allowed for a qualified charitable distribution.

For taxpayers that own any IRA funded with nondeductible contributions, the general rule remains

that withdrawals are treated partly as a nontaxable return of the nondeductible contributions and partly from deductible contributions and earnings (which are subject to tax). However, a qualified charitable distribution is treated as coming first from deductible contributions and earnings.

Example:

Bill, age 72, is the owner of five IRA accounts with an aggregate value of \$150,000. In one of the IRA accounts, Bill has deposited \$30,000 of nondeductible contributions. Bill's required minimum distribution for 2006 is \$5,900. Bill instructs the IRA trustee to make a \$45,000 qualifying charitable distribution to State University. Under PPA 2006, the entire \$45,000 rollover is treated as coming from income first, regardless of the account from which the withdrawal is actually made. In addition, the \$45,000 rollover satisfies the required minimum distribution for

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the year. Bill's remaining aggregate IRA balance of \$105,000 consists of \$75,000 of deductible contributions and earnings and \$30,000 of nondeductible contributions.

[Act. Sec. 1201. IRC Sec. 408(d)(8).]

Planning Pointer:

Participants in 401(k) and 403(b) plans must first rollover to a traditional IRA before taking advantage of a charitable IRA rollover.

Planning Pointer:

The act requires that the entire distribution meet the rules governing charitable deductions. Therefore, extreme care must be exercised to ensure that the donor does not receive any benefit from the charity that would be characterized as more than an insubstantial benefit. For example, because a rollover in exchange for event tickets or in payment of a winning bid at a charitable auction would reduce an otherwise qualifying charitable contribution, such a distribution would not be a qualified charitable distribution.

Planning Pointer:

A donor should receive from the charity a contemporaneous acknowledgment of their gift substantiating their contribution. This

acknowledgement is a required piece of documentation for the rollover to qualify as a charitable distribution.

Planning Pointer:

Rollovers to private foundations, charitable remainder trusts, charitable gift annuities, and pooled income funds are not qualified charitable distributions.

Planning Pointer:

IRA owners may still name any public charity, donor-advised fund, supporting organization, charitable remainder trust, charitable gift annuity, or pooled income fund as the beneficiary of their IRA.

Planning Pointer:

Rollovers to charities by taxpayers who reside in states that tax IRA distributions and do not have a charitable deduction may not escape tax at the state level.

New Tax Basis Benefit for Charitable Contributions of Property by S-Corporations

For tax years 2006 and 2007, S-corporation shareholders are required to adjust the basis of their S-corporation shares only by their pro rata share of the adjusted tax basis of

property contributed to qualifying charitable organizations. As a result, S-corporation shareholders will be able to deduct a larger portion of corporate charitable contributions of property than under previous law. [Act. Sec. 1203, IRC Sec. 1367(a)(2).]

Increased AGI Limit and Carryover Period for Certain Qualified Conservation Contributions

The charitable deduction limitation applicable to qualified conservation contributions has now been increased from 30% of AGI to 50% of AGI in the year of the gift. Additionally, a new 15-year carryover period is now permitted for the excess of the fair market value over the charitable deduction limit. In future years, the carryover amount is subject to the same ordering rules that apply to carryforwards of other charitable deductions.

Example:

Robert makes a qualified conservation contribution valued at \$500,000 in 2006. Robert's AGI in 2006 is \$180,000 and his cash gifts to charity total \$30,000.

Robert's charitable deduction for 2006 consists of the \$30,000 of cash

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gifts *plus* \$60,000 of the qualified conservation contribution (\$180,000 x 50% *minus* \$30,000). Robert may carryover the remaining \$440,000 of unused qualified conservation contribution to 2007 through 2021.

Special Rules for Farmers and Ranchers. For farmers and ranchers who derive more than half of their gross income from farming or ranching, the charitable deduction limitation applicable to qualified conservation contributions of property available for use in agriculture or livestock production is increased to 100% of AGI. To be eligible for this special treatment the gift must contain a restriction that the property must remain available for use in agriculture or livestock production. A 15-year carryover period is allowed for excess contributions.

Qualified conservation contributions that qualify for the 50% of AGI limit must be used to the extent of the 50% limit before applying qualified conservation contributions of property available for use in agriculture or livestock production.

Special Rules for Closely-Held Farming and Ranching Corporations. For closely-held farming and ranching corporations that derive more than half

of their gross income from farming and ranching, the charitable deduction limitation applicable to qualified conservation contributions of property used in agriculture or livestock production has now been increased to 100% of AGI for the year of the gift. Any portion of the contribution, which is not deductible during the year of gift, may be carried over for 15 years subject to the same limitation of 100% of AGI.

There is no enhanced charitable deduction for corporations that do not derive more than half of their gross income from farming or ranching.

Generally, the new qualified conservation contribution provisions apply for contributions made in tax years beginning in 2006 and 2007. The special provisions applicable to qualified conservation contributions of property used for agriculture or livestock production apply to contributions made after August 17, 2006 and before the end of the tax year beginning before January 1, 2008. [Act. Sec. 1206. IRC Secs. 170(b)(1)(E), 170(b)(2).]

UBTI Exemption for Payments To Certain Exempt Controlling Organizations

A payment of interest, annuity, royalty, or rent by a controlled organization to an exempt parent is now excludable from UBTI so long as:

- The payment is made pursuant to either a binding, written contract in effect on August 17, 2006, or a renewal of such a contract under similar terms; and
- The payment is a fair allocation between the controlling and controlled organization.

A controlled organization is an organization of which at least 50% of the outstanding voting stock, profits interest, or beneficial interest is owned by an exempt organization.

An additional tax of 20% will be assessed to the controlling organization on any amounts deemed to be in excess of a fair allocation. [Act. Sec. 1205(a). IRC Sec. 512(b)(13)(E).]

Controlling organizations are now required to report information regarding payments from and loans to controlled organizations.

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The Act requires the Treasury Secretary to prepare a report to Congress on the IRS's effectiveness in administering this provision, including the results of audits of controlling and controlled organizations. [Act. Sec. 1205(b). IRC Sec. 6033(h).]

The change is effective for payments made between January 1, 2006 and December 31, 2007. [Act. Sec. 1205(c).]

Hidden Trap:

Because the statute requires that the binding written agreement be in place by the enactment of the statute, new agreements (not including renewal agreements) entered into after August 17, 2006 will not qualify for this benefit.

New Reporting Requirement for Certain Charity-Owned Life Insurance Contracts

Charities must now report identifying information about certain life insurance contracts acquired through structured transactions involving a pool of such contracts. Failure to file this information with the Internal Revenue Service will result in the assessment of a penalty equal to the greater of \$1000 or 10% of the value of the benefit in any contract, which must be disclosed.

The requirement applies to life insurance contracts, annuity contracts, and endowment contracts in which both a charity and another person have at any time held an interest. Exceptions to the reporting requirement include:

- Contracts in which each person other than the charity have an insurable interest in the insured (without relying on the charity's insurable interest);
- Contracts in which the only interest a charity and any other person holds is as a named beneficiary;
- Contracts in which the sole interest of a person other than a charity is as a beneficiary of the trust, so long as the beneficial interest was received as a purely gratuitous transfer; and
- Contracts in which the sole interest of a person other than a charity is as a trustee who holds an interest in a contract described in the previous exceptions.

This reporting requirement is in response to a number of "charity owned life insurance" (CHOLI) arrangements that have been promoted in recent years. Much has been written about the wagering

aspect of many of these plans that have become known as "dead pools."

This reporting requirement applies to contracts acquired between August 17, 2006 and August 17, 2008.

The Treasury Secretary is charged with conducting a study of the use of CHOLI contracts to share the benefits of the charity's insurable interest with investors and whether the use of such contracts is consistent with their tax exempt status. The report is due on February 17, 2009. [Act. Sec. 1211. IRC Secs. 6050V, 6721(e)(2)(D), 6724(d)(1)(B)(xiv).]

Increase in Penalty Excise Taxes Assessed Against Public Charities and Private Foundations

In general, the initial excise taxes imposed by chapter 42 are doubled. These include the initial excise tax for self-dealing, failure to distribute income from a private foundation, excess business holding, jeopardizing investments, taxable expenditures, and excess benefit transactions.

Comment:

In general, the excise taxes imposed by Chapter 42 also apply to

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charitable remainder trusts, charitable lead trusts, and pooled income funds.

This change is effective for tax years beginning after August 17, 2006. [Act. Sec. 1212. IRC Secs. 4941(a), 4941(c)(2), 4942(a), 4943(a)(1), 4944(a), 4944(d)(2), 4945(a), 4945(c)(2), 4958(d)(2).]

Contributions of Façade Easements for Buildings in Registered Historic Districts

A taxpayer who owns a building in a registered historic district and wishes to qualify for a deduction for a façade easement must follow new guidelines. In general, gifts made after July 25, 2006 must be evidenced by a written agreement that:

- Includes a restriction which preserves the entire exterior of the building (front, rear, sides, and height);
- Prohibits any change in the exterior of the building that is inconsistent with the historical character of the building; and
- Under penalty of perjury is entered into with a qualified organization that has the resources and commitment to

manage and enforce the restriction.

A qualified organization is:

- A governmental unit;
- A charity that meets the public support test of IRC §170(b)(1)(A)(vi);
- A charity that meets the public support test of IRC §509(a)(2); or
- A supporting organization controlled by any one of the three types of charities listed above.

In addition, the qualified organization that receives such gifts, must also be organized for the purpose of environmental protection, land conservation, open space preservation, or historic preservation.

For contributions made in a taxable year beginning after August 17, 2006, taxpayers claiming this deduction must include with their return:

- A qualified appraisal of the interest contributed;
- Photographs of the entire exterior of the building; and
- A description of all restrictions placed on the development of the building.

Taxpayers that claim a deduction of more than \$10,000 for contributions of façade easements after February 13, 2007, must include a \$500 filing fee with their return. By statute, this fee is earmarked for enforcement of the new rules governing the deductibility of all types of qualified conservation contributions, including façade easements.

Effective August 17, 2006, no deduction is allowed for a qualified conservation contribution of a structure or land unless the structure or land is listed in the National Register. [Act. Sec. 1213. IRC Secs. 170(h)(4)(B), (C), 170(f)(13), 170(f)(14).]

Recapture of Deduction Claimed for Contributions of Tangible Personal Property

Contributions of "related use" tangible personal property which is sold, exchanged, or otherwise disposed of within three years of contribution are now potentially subject to recapture of the deduction claimed.

If the charity sells, exchanges, or otherwise disposes of the property during the tax year in which the contribution is made, the donor's deduction is simply limited to the

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donor's adjusted tax basis in the property. If the charity disposes of the property after the end of the tax year in which the contribution is made and before the last day of the 3-year period starting on the date of the gift, then the donor must include in ordinary income an amount equal to the excess of the deduction claimed over the donor's adjusted tax basis in the property.

Example:

Susan contributes a stamp collection to the Hanover Philatelic Museum. The museum expects to put the collection on display. The collection is valued at \$300,000 and Susan's adjusted tax basis for the collection is \$5,000. Two years after Susan's contribution, the museum sells the collection to a private collector for \$400,000. In the year of sale, Susan must include in ordinary income \$295,000 (\$300,000 *minus* \$5,000).

Hidden Trap:

It is possible (perhaps even likely) that the applicable marginal tax rate in the year in which the deduction was claimed will be lower than the applicable marginal tax rate in the year in which the deduction is recaptured. Therefore, the tax liability created from the inclusion of the recapture amount may exceed the tax savings realized

from claiming the deduction. It is often the case that a \$300,000 deduction has a different relative impact on a taxpayer's tax burden than a \$300,000 item of income. For example, the inclusion of an item in income will cause an increase in AGI and a ripple effect through such items as taxation of Social Security benefits, the loss of the child tax credit, reduction in personal exemptions, reduction in itemized deductions, an increase in the 2% floor for miscellaneous itemized deductions, and an increase in the 7.5% floor for deductible medical expenses.

Recapture can be avoided if an officer of the charity in a written statement, under penalty of perjury:

- Certifies that the use of the property was a related use and describes how the property was used and how this use furthered its charitable mission; or
- States the charity's intended use of the property at the time of contribution and certifies that this intended use has become impossible or infeasible to implement.

Example:

In the example above, if the Hanover Philatelic Museum prepares a

certification that meets the new rules, then Susan will not be required to include any amount in ordinary income as a result of the sale of the collection.

In addition, any person that identifies tangible personal property a related use property and knows that the property is not intended for a related use will be assessed a \$10,000 penalty.

The deduction recapture rules apply to contributions of "related use" tangible personal property after September 1, 2006. The new \$10,000 penalty is effective for identifications made after August 17, 2006. [Act. Sec. 1215. IRC Secs. 170(e)(1)(B)(i), 170(e)(7), 6050L(a), 6720B.]

New Three Year Reporting Period for Form 8282

The time period for filing Form 8282, *Donee Information Return (Sale, Exchange, or Other Disposition of Property)*, has now been extended to three years from the date of contribution for all types of property.

Charities are now required to attach to Form 8282 a statement certifying the related use of tangible personal property that has been sold, exchanged, or otherwise disposed.

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The change to Form 8282 is effective for forms filed after September 1, 2006. [Act. Sec. 1215(b). IRC Sec. 6050L(a).]

Comment:

Many charities that received property contributions between September 1, 2003 and September 1, 2004 will have already aged those properties out of their Form 8282 tracking systems. Those properties are now subject to the new Form 8282 reporting period if they are disposed of within the 3-year period beginning on the date of contribution.

Enhanced Recordkeeping Requirement for Contributions of Money

To receive a deduction for contributions of money, a donor must retain either a bank record or a written communication from the charity showing the name of the charity and the date and amount of the contribution. This requirement applies to all contributions made in taxable years beginning after August 17, 2006. [Act. Sec. 1217. IRC Sec. 170(f)(17).]

Comment:

To comply with this new requirement, a donor may no longer rely on contemporaneous notations of cash contributions, a check register, or other self-created records of cash contributions. Only a canceled check, bank record, or receipt issued by the charity will suffice.

Gifts of Fractional Interests in Tangible Personal Property

An income, gift, and estate tax contribution deduction is only allowed for gifts of a fractional interest in tangible personal property if the donor and the donee are the only parties that hold an interest in the property immediately prior to the contribution. Where property is owned by multiple persons, the Secretary of the Treasury may issue regulations permitting an income and gift tax contribution deduction for such a gift if all owners contribute a pro rata share of their interests in the property.

The fair market value used in valuing additional gifts of fractional interests in the same property is the lesser of the fair market value at the date of the first contribution and the fair market value at the date of the additional contribution.

Example:

On November 11, 2006, Art C. Lector contributes a 20% interest in a sculpture to the local art museum. Two years later, when the sculpture has tripled in value, Art gives the remaining 80% interest in the sculpture to the museum. Because the sculpture appreciated in value, Art's contribution deduction is based on the sculpture's November 11, 2006 fair market value (the date of his initial fractional gift).

The contribution deduction allowed for income and gift tax is subject to recapture (with interest) if the charity does not receive all the remaining interest in the property within ten years of the gift or the date of the donor's death, whichever is earlier. In addition, recapture is triggered if during this period the charity does not take physical possession of the property and use the property in a use related to its exempt purpose. If recapture is triggered, an additional penalty tax of 10% of the recaptured amount is imposed for both income and gift tax.

This provision is effective for contributions made after August 17, 2006. [Act. Secs. 1218. IRC Secs. 170(o), 2055(g), 2522(f).]

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Changes to Thresholds for Determining Substantial and Gross Valuation Misstatements

If the tax reported by a taxpayer is understated due to a substantial misstatement of the value of property, then an accuracy related penalty of 20% of the understated tax is imposed. If the misstatement is determined to be a gross misstatement of the value, then the accuracy related penalty is increased to 40% of the understated tax.

The thresholds for determining that a misstatement has occurred have been tightened as illustrated in the following table.

Substantial Misstatement	
Current Law	PPA 2006
Income Tax	
200% or more of the amount determined to be correct	150% or more of the amount determined to be correct
Estate and Gift Tax	
50% or less of the amount determined to be correct	65% or less of the amount determined to be correct

Gross Misstatement	
Current Law	PPA 2006
Income Tax	
400% or more of the amount determined to be correct	200% or more of the amount determined to be correct
Estate and Gift Tax	
25% or less of the amount determined to be correct	40% or less of the amount determined to be correct

In general, the provisions modifying the thresholds applicable to valuation misstatements are effective for returns filed after August 17, 2006. Where the valuation misstatement arises from an appraisal of a façade easement, the provisions related to valuation misstatements are effective for returns filed after July 25, 2006. [Act. Sec. 1219. IRC Secs. 6662(e)(1), 6662(h)(2), 6664(c)(2), 6695A.]

Changes to Qualified Appraisals

A new penalty will be imposed on appraisers who knowingly prepare an appraisal to be used in connection with a return that results in an underpayment of tax due to a substantial or gross valuation

misstatement. The penalty is the lesser of:

- The greater of 10% of the understatement in tax resulting from the valuation misstatement, or \$1,000; or
- 125% of the fee received by the appraiser.

The penalty may be avoided if the appraiser can demonstrate that the appraised value was “more likely than not” the proper value.

The Act also sets new standards for determining that an appraiser is a qualified appraiser. In general, a qualified appraiser is an individual:

- Certified by a professional appraiser organization;
- That regularly performs appraisals for which he or she is compensated;
- That can demonstrate verifiable education and experience valuing the type of property appraised; and
- That has not been prohibited from practicing before the IRS during the 3-year period ending on the date of appraisal.

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The Act repeals the reasonable cause exception for underpayments due to gross valuation misstatements. [Act. Sec. 1219(a). IRC Sec. 6664(c)(2).]

In general, the provisions establishing new standards for qualified appraisers are effective for returns filed after August 17, 2006. For contributions of a façade easement, the new qualified appraiser standards are effective for returns filed after July 25, 2006. [Act. Sec. 1219. IRC Secs. 170(f)(11)(E), 6662(e)(1), 6662(h)(2), 6664(c)(2), 6695A.]

Expansion of the Definition of Private Foundation Net Investment Income Subject to the 2% Excise Tax

Private foundations must pay an excise tax of 2% on their net investment income. Under current law, capital gains includible in gross income are limited to gains from the sale or other disposition of property used for the production of interest, dividends, rents, and royalties. The Act expands the definition of net investment income to include capital gains (and losses to the extent of capital gains) from the sale or other disposition of all property used for the production of gross investment income. According to the

technical explanation produced by the Joint Committee on Taxation, the expanded language is intended to override the existing regulatory exception for program related investments. The Act also explicitly disallows carrybacks of capital losses.

An exception is allowed for sales or other dispositions of property used in furtherance of a foundation's exempt purpose for not less than one year that is immediately exchanged for like kind property that is to be used in furtherance of the foundation's exempt purpose. The exchange is to be governed by rules similar to those governing IRC Sec. 1031 exchanges.

The amendments expanding the definition of net investment income are effective for taxable years beginning after August 17, 2006. [Act. Sec. 1221. IRC Secs. 509(e), 4940(c).]

Annual Notification Requirement for Small Charities

Charities with gross receipts of not more than \$25,000 are generally exempt from filing Form 990 or 990EZ. The Act creates a new requirement that such charities electronically file an annual notice with the IRS. The notice must include:

- The legal name of the charity;
- Any name under which it operates or does business;
- The charity's mailing address and website address;
- The charity's taxpayer identification number;
- The name and address of the charity's principal officer; and
- Evidence of the continuing basis for the charity's exempt status.

Small charities that terminate their operations must file a notice of termination.

This section of the Act is effective for notices filed for annual periods beginning after 2006. [Act. Sec. 1223(a). IRC Sec. 6033(i).]

Comment:

It is unclear what will constitute sufficient evidence of the continuing basis for a charity's exempt status. Until guidance is issued, charities should be prepared to produce a short narrative summary of their activities. The activities described should correspond to the exempt purpose included on the charities application for exemption.

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Revocation of Exempt Status for Failure to File

If a charity that is required to file Form 990 or the notice described in new IRC Sec. 6033(i) fails to file for three consecutive years, then the charity's exempt status is automatically revoked. Treasury is required to maintain a list of charity's whose exempt status has been revoked.

A charity must file a new application to reinstate its exempt status. Reinstatement is retroactive if the charity can show reasonable cause for its failure to file. Unlike Form 990, there is no monetary penalty for failure to file the notice required by new IRC Sec. 6033(i). A charity whose exempt status is revoked due to failure to file may not seek a declaratory judgment.

Treasury is required to notify in writing all charities of the new notice requirement and revocation penalty for failure to file. The Treasury is also instructed to use the Internet or other means of outreach in order to ensure that all affected charities are informed of the new requirements. [Act. Sec. 1223(b), (c), (d), (e). IRC Secs. 6033(j), 6652(c)(1)(E), 7428(b)(4).]

This section of the Act is effective for notices and returns filed for annual periods beginning after 2006.

Disclosure to State Agencies

Under current law, the Secretary of the Treasury is permitted to disclose to state officials his refusal to grant exempt status to a charity or the issuance of a notice of deficiency of tax imposed under IRC Sec. 507 (the termination tax) or chapter 41 or 42 (related to excise taxes on prohibited activities). The Act expands the types of disclosures that the Secretary of the Treasury is permitted to make to state officials to include:

1. A notice of proposed refusal to grant a charity exempt status under IRC Sec. 501(c)(3);
2. A notice of proposed revocation of a charity's exempt status;
3. The issuance of a proposed deficiency of tax under IRC Sec. 507 or chapter 41 or 42;
4. The names, addresses, and taxpayer identification numbers of organizations that have applied for exempt status under IRC Sec. 501(c)(3); and
5. Returns and return information related to items 1 through 4.

Disclosure is only permitted upon the submission of a written request by an appropriate State officer and solely for the purpose of and to the extent necessary to administer State laws regulating exempt organizations. [Act. Sec. 1224(a). IRC Secs. 6104(c)(2)(A), (B), (C).]

Appropriate State officers include the State attorney general, or his designee; the State tax officer, or his designee; any State official charged with the oversight of exempt organizations; and the head of the State agency responsible for overseeing the solicitation of funds for charitable purposes.

The Secretary of the Treasury may also disclose the returns and return information of exempt organizations if he determines that they constitute evidence of noncompliance under State law. [Act. Sec. 1224(a). IRC Sec. 6104(c)(2)(D).]

The amendments made by this section are effective for requests made after August 17, 2006.

Public Inspection of Form 990-T

The Act requires that Form 990-T related to the reporting of unrelated

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business income tax be made available for public inspection. The amendment is effective for returns filed after August 17, 2006. [Act. Sec. 1225. IRC Sec. 6104(d)(1)(A)(ii).]

Study of Donor Advised Funds and Supporting Organizations

The Act requires the Secretary of the Treasury to conduct a study of donor advised funds and supporting organizations to consider:

1. Whether the income, estate, and gift tax deductions allowed for contributions to donor advised funds and supporting organizations are appropriate given the use of contributed assets by the sponsoring organization and the use of contributed assets for the benefit of the person making the charitable contribution;
2. Whether donor advised funds should be subject to a minimum distribution requirement in order to ensure that the sponsoring organization is acting in accordance with the purpose for which it was granted an exemption;
3. Whether the retention of advisory rights (or other rights and

privileges) by donors over contributions to a donor advised fund or supporting organizations is consistent with the treatment of such contributions as completed gifts that qualify for a deduction for income, estate, and gift taxes; and

4. Whether any issues raised in the preparation of the report are issues with respect to other types of charities or charitable contributions.

The report must be submitted to the Committee on Finance of the Senate and the Committee on Ways and Means of the House by August 17, 2007. [Act. Sec. 1226.]

Donor Advised Funds Defined

For the first time the Act provides a statutory definition of a donor advised fund. A donor advised fund is a fund or account:

1. In which the contributions of one or more donors are separately identified;
2. Which the sponsoring organization owns and controls; and
3. For which the donor (or the donor's designee), by virtue of

the donor's status as a donor, has advisory rights (or reasonably expects to have such rights) with respect to the distribution or investment of amounts held in the fund or account.

Donor advised funds do not include any fund or account which only makes distributions to a single, identified charity or governmental entity. In addition a fund for which a donor (or the donor's designee) advises as to which individuals will receive grants for travel, study, or other similar purposes is not a donor advised fund so long as:

1. The advisory privileges are performed exclusively in the advisor's capacity as a member of a committee whose members are appointed by the sponsoring organization;
2. No combination of donors to the fund (or persons related to donors to the fund) has direct or indirect control of the committee; and
3. All grants are awarded on an objective and nondiscriminatory basis pursuant to a procedure that is approved by the board of the sponsoring organization and is designed to meet the general

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requirements of IRC Sec. 4945(g)(1), (2), or (3).

[Act Sec. 1231. IRC Sec. 4966(d)(2).]

The sponsoring organization of a donor advised fund must be a charity described in IRC Sec. 170(c) that is not a governmental unit, nor a private foundation. [Act Sec. 1231. IRC Sec. 4966(d)(1).]

Comment:

The definition of a sponsoring organization does not exclude a supporting organization from being a sponsoring organization of a donor advised fund program. In addition, there is no requirement that a sponsoring organization be created or organized in the United States. However, contributions to a donor advised fund at a limited subset of organizations are not eligible for an income, estate, or gift tax charitable deduction.

This section is effective for taxable years beginning after August 17, 2006. [Act. Sec. 1231. IRC Sec. 4966(d).]

Excise Taxes on Certain Donor Advised Fund Distributions

The Act levies an excise tax on the sponsoring organization of 20% of any taxable distribution. [Act. Sec. 1231(a). IRC Sec. 4966(a).] A taxable distribution is a distribution from a donor advised fund:

1. To any natural person; or
2. To any other person if not used exclusively for religious, charitable, scientific, literary, or education purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals. [IRC Sec. 170(c)(2)(B).]

An exception is allowed for distributions to an entity described in item 2 if the sponsoring organization exercises expenditure responsibility with respect to the distribution as described at IRC Sec. 4945(h). In addition, distributions to public charities (but not disqualified supporting organizations), to the sponsoring organization of a donor advised fund, or to any other donor advised fund are exempted from the excise tax. [Act. Sec. 1231(a). IRC Sec. 4966(c).]

As noted, disqualified supporting organizations are not permissible recipients of donor advised fund distributions. A disqualified supporting organization is:

1. A Type I or Type II supporting organization or a Type III functionally integrated supporting organization, that has a supported organization which is directly or indirectly controlled by the donor of the donor advised fund, or the donor's designee;
2. A Type I or Type II supporting or a Type III functionally integrated supporting organization, which is deemed an inappropriate recipient by regulation; or
3. A Type III supporting organization that is not a functionally integrated Type III supporting organization.

A functionally integrated supporting organization is defined at 4943(f)(5)(B). [Act. Sec. 1231(a). IRC Sec. 4966(d)(4).]

A fund manager that knowingly approves a taxable distribution is also subject to an excise tax of 5% of the taxable distribution, up to a maximum of \$10,000. If more than one fund manager approves a taxable distribution, then each fund manager is

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jointly and severally liable for the tax. [Act. Sec. 1231(a). IRC Secs. 4966(a), (b), (d)(3).]

If a sponsoring organization makes a distribution from a donor advised fund on the advice of any person and the distribution results in a disqualified person (as defined at IRC Sec. 4958(f)(7)) receiving, directly or indirectly, a more than incidental benefit, the Act imposes on the person that advised with respect to the distribution, an excise tax of 125% of the distributed amount. If a fund manager agreed to make the distribution knowing that it would result in a disqualified person receiving a more than incidental benefit, then an excise tax equal to 10% of the benefit is imposed on the fund manager. The maximum amount of the excised tax imposed on a fund manager is \$10,000. If more than one person gave advice with respect to this type of distribution or more than one fund manager knowingly agreed to the distribution, then each such person is jointly and severally liable for their respective tax. [Act. Sec. 1231. IRC Sec. 4967.]

This section is effective for taxable years beginning after August 17, 2006.

Application of Excess Benefit Transaction Rules to Donor Advised Funds

The Act expands the definition of "excess benefit transaction" to include grants, loans, compensation, or other similar payments from a donor advised fund to:

1. A donor (or the donor's designee), who by virtue of the donor's status as a donor, has advisory rights (or reasonably expects to have such rights) with respect to the distribution or investment of amounts held in a donor advised fund;
2. A member of the family of a person described in item 1; or
3. A corporation, partnership, limited liability company, or trust in which more than 35% of the controlling interest is owned by one or more persons described in item 1 or 2.

[Act Sec. 1232. IRC Sec. 4958(f)(7).]

The entire amount of the transaction is an excess benefit. Any funds repaid to a sponsoring organization in correction of an excess benefit transaction may not be held in a donor advised fund. [Act Sec. 1232. IRC Secs. 4958(c)(2), 4958(f)(6).]

This amendment is effective for transactions occurring after August 17, 2006.

Application of Excess Business Holdings to Donor Advised Funds

In general, under current law a private foundation that holds (together with disqualified persons) more than 20% of the controlling interest in a business enterprise (an excess business holding) is subject to the excess business holdings provisions of IRC Sec. 4943. A private foundation is not treated as having excess business holdings if it owns not more than 2% of the voting interest and not more than 2% of the outstanding value of all classes of interests.

The Act extends the excess business holdings rules to business interests held in a donor advised fund. The definition of disqualified persons for the purpose of aggregating the holdings of the donor advised fund and disqualified persons is same as the definition of a disqualified person under the excess benefit transaction rules.

Comment:

For the purpose of determining if a donor's donor advised fund at a sponsoring organization has excess

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business holdings, the Act omits any requirement to aggregate holdings in the donor's donor advised funds held at any other sponsoring organizations.

Special transition rules are provided for excess business holdings in a donor advised fund at August 17, 2006. The amendments of this section are effective for tax years beginning after August 17, 2006. [Act. Sec. 1233. IRC Secs. 4943(c), (e), 4966(d)(2), 4958(f)(3).]

Limitations on Charitable Deductions for Gifts to Donor Advised Funds

To obtain an income, estate, or gift tax charitable deduction for a gift to a donor advised fund, the sponsoring organization must issue a contemporaneous, written acknowledgement that states that organization has exclusive legal control over the assets contributed and conforms to the substantiation requirements of IRC Sec. 170(f)(8)(C).

In addition, the sponsoring organization must not be a non-Type III functionally integrated supporting organization, or described in IRC Sec. 170(c)(3), (4), or (5) [related to the income tax], 2055(a)(3) or (4) [related

to the estate tax], or 2522(a)(3) or (4) [related to the gift tax].

This amendment is effective for gifts made after February 13, 2007. [Act Sec. 1234. IRC Sec. 170(f)(18).]

Returns of Organizations That Sponsor Donor Advised Funds

The Act requires that organizations that sponsor donor advised funds report on their tax return:

1. The total number of donor advised funds;
2. The aggregate value of donor advised funds;
3. The aggregate value of contributions to donor advised funds; and
4. The aggregate value of grants from donor advised funds.

In addition, newly formed organizations that wish to become sponsoring organizations must disclose this intent on their application for exempt status.

The amendment related to reporting by sponsoring organizations is effective for tax years ending after August 17, 2006. The amendment related to new exemption applications

is effective for application files after August 17, 2006. [Act. Sec. 1235. IRC Secs. 508(f), 6033(k).]

New Requirements for Certain Supporting Organizations

In order to satisfy the responsiveness test, the Act requires that Type III supporting organizations supply to each supported organization, such information as may be required by the Secretary of the Treasury. [Act. Sec. 1241(b). IRC Sec. 509(f)(1)(A).]

Type I and Type III supporting organizations may no longer accept contributions from persons (including family members and entities controlled by such persons) that control, directly or indirectly, the governing body of a supported organization. An exception is allowed for contributions from charities described in 509(a)(1), (2), and (4). [Act. Sec. 1241(b). IRC Sec. 509(f)(2).]

These amendments are effective on August 17, 2006.

Prohibition on Type III Supporting Organizations That Support a Foreign Charity

The Act states that an organization will not qualify as a Type III supporting

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organization if it is operated in connection with any organization organized outside the United States.

The effective date of this amendment for existing Type III supporting organizations that have a foreign charity as a supported organization have until the first day of the third taxable year beginning after August 17, 2006. [Act. Sec. 1241(b). IRC Sec. 509(f)(1)(B).]

Planning Pointer:

Generally, this will require an amendment to the organization's organizing documents, notice to the Internal Revenue Service and possibly notification to the State in which the organization is organized.

New Restrictions on Use of Charitable Trusts for Type III Supporting Organizations

A charitable trust will no longer be considered to operate in connection with a supported organization solely because:

1. It is a charitable trust under State law;
2. The supported organization is a beneficiary of the trust; and

3. The supported organization has the power to enforce the trust and compel an accounting.

This amendment is effective August 17, 2007. [Act. Sec. 1241(c).]

Comment:

This provision of the Act eliminates an exception under Treas. Reg. Sec. 1.509(a)-4(i)(2)(iii). Many Type III supporting organizations were established as charitable trusts in order to use this exception to satisfy the responsiveness test described in Treas. Reg. Sec. 1.509(a)-4(i)(2). Trustees of these supporting organizations must now comply with same responsiveness test required of supporting organizations organized as a nonprofit corporation or limited liability company.

Application of Excess Benefit Transaction Rules to Supporting Organizations

The Act expands the definition of "excess benefit transaction" to include grants, loans, compensation, or other similar payments from a supporting organization to:

1. A substantial contributor to the supporting organization;

2. A family member of a substantial contributor; or
3. A corporation, partnership, limited liability company, or trust in which more than 35% of the controlling interest is owned by one or more persons described in item 1 or 2.

In addition, any loan from the supporting organization to a disqualified person defined in IRC Sec. 4958(f)(1) other than a charity described at IRC Secs. 509(a)(1), (2), or (4).

The entire amount of the transaction is an excess benefit.

This amendment is effective for transactions occurring after July 25, 2006. [Act Sec. 1242. IRC Secs. 4958(c)(3), 4958(f)(1)(D).]

Application of Excess Business Holdings to Supporting Organizations

In general, under current law a private foundation that holds (together with disqualified persons) more than 20% of the controlling interest in a business enterprise (an excess business holding) is subject to the excess business holdings provisions of IRC Sec. 4943. A private foundation is

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not treated as having excess business holdings if it owns not more than 2% of the voting interest and not more than 2% of the outstanding value of all classes of interests.

The Act extends the excess business holdings rules to business interests held by a limited set of Type II and Type III supporting organization. An extremely complex set of aggregation rules applies to determine whether a business interest is a permitted holding. In general, the holdings of the following persons are aggregated:

1. Substantial contributors, their family members, and entities in which they have a greater than 35% interest;
2. Persons with substantial influence over the supporting organization during the past five years, their family members, and entities in which they have a greater than 35% interest; and
3. Charities that are controlled by or receive substantial funding from persons described in items 1 and 2.

The State attorney general or other State official having jurisdiction over a Type III supporting organization may exempt certain business holdings held

as of November 18, 2005 that are held for the benefit of the community.

Special transition rules are provided for excess business holdings in a supporting organization at August 17, 2006. The amendments of this section are effective for tax years beginning after August 17, 2006. [Act. Sec. 1243. IRC Secs. 509(a)(3), 4943(c), (f), 4958(f).]

Payments from Private Nonoperating Foundations to Supporting Organizations

Under current law, a private nonoperating foundation is required to distribute an amount equal to 5% of its net investment assets. The Act provides that a distribution from a private nonoperating foundation to:

1. A non-functionally integrated Type III supporting organization; or
2. A Type I or II supporting organization or a functionally integrated Type III supporting organization, if, either the supporting organization or a supported organization is directly (or indirectly) controlled by a disqualified person of the private foundation

is not a qualifying distribution under IRC Sec. 4942(g) and is a taxable expenditure under IRC Sec. 4945.

This amendment is effective for distributions and expenditures made after August 17, 2006. [Act. Sec. 1244. IRC Secs. 4942(g)(4), 4945(d)(4).]

Returns of Supporting Organizations

The Act requires that on the annual return of a supporting organization, it must:

1. List its supported organizations;
2. Identify the type of supporting organization; and
3. Certify that the supporting organization is not controlled by a disqualified person or person under IRC Sec. 4946 (other than the foundation manager or managers).

This amendment applies to returns filed for taxable years ending after August 17, 2006. [Act. Sec. 1245. IRC Sec. 6033(l).]

Changes to Split-Interest Trust Filing Requirements

Split-interest charitable trusts are now required to file each year, such

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form as the Secretary of the Treasury may require. Historically this has been Form 1041-A, *Trust Accumulation of Charitable Amounts*. The Act eliminates the current exception that exempted such trusts from filing the form if all of the net income of the trust was distributed currently. The exception continues to apply to non-charitable trusts that must file Form 1041-A as a result of claiming a deduction under IRC Sec. 642(c). [Act. Sec. 1201(b)(1), IRC Sec. 6034.]

Comment:

This change impacts charitable remainder trusts, charitable lead trusts, and pooled income funds. It remains to be seen whether Treasury will create a new form for split-interest charitable trusts or continue to use Form 1041-A.

In addition, the penalty for failure to file the form required by new IRC Sec. 6034(a) is increased from \$10 to \$20 for each day the form is late. The maximum penalty that may be imposed is increased from \$5,000 to \$10,000. However, for certain large trusts with gross income in excess of \$250,000, the penalty is \$100 per day up to a maximum of \$50,000 [Act. Sec. 1201(b)(2), IRC Sec. 6652(c)(2)(C).]

Under current law, Form 1041-A is subject to public inspection. The Act

clarifies that information regarding the noncharitable beneficiaries of charitable split-interest trusts is not subject to public inspection. [Act. Sec. 1201(b)(3), IRC Sec. 6104(b).]

This amendment is effective for tax years beginning after December 31, 2006.

Miscellaneous Provisions

Food and Book Inventory. The enhanced charitable deduction for qualifying gifts of food and book inventory is extended through the end of 2007. [Act. Secs. 1202, 1204. IRC Secs. 170(e)(3)(C)(iv), 170(e)(3)(D)(iv).]

Taxidermy Gifts. Current law limits the contribution deduction for gifts of tangible personal property to a donor's adjusted tax basis unless the charity uses the property in a manner that is related to the charity's exempt function (the related use exception). Gifts that qualify for the related use exception are deductible at fair market value.

Under the Act, gifts of taxidermy property no longer qualify for the related use exception. In addition, the statute makes clear that the basis of the property only includes the direct costs of preparing, stuffing, and

mounting the animal. This provision is effective July 25, 2006. [Act. Sec. 1214. IRC Secs. 170(e)(1)(B)(iv), 170(f)(15).]

Qualified Conservation Contributions and the Rehabilitation Credit. A taxpayer who makes a qualified conservation contribution, must reduce the amount of contribution by a portion of any rehabilitation credit claimed in the five previous years. This provision applies to any qualified conservation contribution made after August 17, 2006. [Act. Sec. 1213(d). IRC Sec. 170(f)(14).]

New Limitation on Charitable Contributions of Clothing and Household Items. In order to qualify for a charitable contribution deduction, contributed clothing and household items must be in "good used condition or better." The Treasury Department may issue regulations denying a deduction for items of minimal value. This rule will not apply where the contribution of a single item of clothing or a single household item is valued at more than \$500 and qualified appraisal is included with the donor's return. The new limitation applies to contributions made after August 17, 2006. [Act. Sec. 1216. IRC Sec. 170(f)(16).]