

Senate Passes Tax Legislation with Significant Exempt Organization Reforms, Anti-Abuse Rules, and Charitable Giving Incentives

November 19, 2005

On November 18, 2005, the Senate passed the Tax Relief Act of 2005 (S. 2020), which contains several significant modifications to the tax rules governing exempt organizations and charitable giving. The companion legislation to be considered by the House of Representatives in December is smaller in scope and does not currently contain these charitable provisions. Thus, it remains unclear which, if any, of these provisions will be included in a final legislative package.

The Senate bill would provide new incentives and anti-abuse rules for individual and corporate donors, as well as more reporting, higher penalties, and increased disclosure requirements for many exempt organizations. The provisions would also change the rules governing how donor-advised funds, supporting organizations and credit counseling agencies must be organized and operated to maintain their exempt status. Following recent trends in tax legislation, some of the provisions would be "temporary" tax changes, and would expire on January 1, 2008, absent further legislation. Senate Finance Committee Chairman Grassley has indicated that further legislation in this area is under consideration.

Several of the more significant provisions included in the Senate bill are summarized below.

Charitable giving incentives with new limits and anti-abuse rules for taxpayers

- **IRA charitable rollovers:** Individual taxpayers would be able to exclude from their taxable income qualifying funds withdrawn from traditional or Roth Individual Retirement Accounts. Funds contributed directly to charitable organizations would qualify if the taxpayer is 70½ or older, and contributions made to a charitable remainder annuity trust or charitable remainder unitrust would qualify for taxpayers 59½ or older.
- **Non-itemizer charitable contribution deductions:** The deduction for charitable contributions currently available to itemizing taxpayers would be extended to individual taxpayers who do not itemize their tax deductions.
- **New floor on charitable contribution deductions:** Individual taxpayers, both itemizing and non-itemizing, would not be able to deduct the first \$210 (\$420 for joint filers) of charitable contributions.
- **Substantiation of donations:** Deductions for gifts of clothing and household goods would be limited to set amounts assigned to such items by the IRS, and donors would be required to obtain an itemized list of the donated items, including an indication of their condition, from

the charity. Donors would be required to retain a cancelled check or obtain a receipt for *all* cash gifts. For gifts of \$250 or more, donors would still be required to obtain a written acknowledgment from the charity.

- **Donations of self-created literary, musical, artistic, and scholarly compositions:** Authors or creators of such works would be able to deduct their contributions at fair market value where certain requirements are satisfied.
- **Contributions of fractional interests in property:** In response to news reports of donations of fractional interests in tangible personal property (particularly artwork) where the donated property never leaves the donor's home, charities would be required to take actual possession of the donated item for a period of time corresponding to the charity's percentage interest in the item. The proposal would also impose new requirements on how subsequent charitable donations of interests in the same property are valued.
- **Modification of rules applicable to valuations of property and appraisals:** The proposal would lower the thresholds for imposing accuracy-related penalties on a taxpayer who claims a deduction for donated property for which an appraisal is required. The proposal would eliminate the reasonable cause exception to the accuracy-related penalty in cases of gross valuation misstatements (when the claimed value of the donated property is 200% or more of the amount determined to be the correct value). The proposal also would provide a stricter definition of who is a "qualified appraiser."
- **Limitation of tax benefit for tangible personal property not used for an exempt purpose:** Tangible personal property that is contributed to an exempt organization for use in furtherance of the organization's exempt purpose may be deducted by the donor at fair market value. However, if the organization disposes of the property within three years, and the charitable contribution deduction was in excess of \$5,000, the donor would be required to include as ordinary income (in the year of disposition) the difference between the fair market value of the item and its basis.
- **Donations of book and food inventory:** Currently, qualified business taxpayers may generally only take a deduction for the lesser of fair market value or basis of donated book or food inventory. Under this provision, the deduction would allow the lesser of fair market value or twice the basis of donated property.
- **Donations of real property for conservation purposes:** Contributions of real property interests for conservation purposes would qualify for enhanced deductions, with farmers and ranchers receiving additional benefits.
- **Charitable contributions of property by S corporations:** S corporation stock basis would be reduced by each shareholder's pro rata share of basis in donated property (rather than the pro rata fair market value of donated property, as required under current law).
- **Reimbursement of mileage for charitable volunteers excludible from income:** Reimbursements for use of a personal automobile for the benefit of a charitable organization would not be included as income for the recipient.

- **Deduction for corporate donations of computer technology and equipment:** The current enhanced deduction for computer technology and equipment for educational purposes would be extended an additional year to apply to taxable years beginning before December 31, 2006.

- **Enhanced corporate deductions for the Mathematics and Science Partnership Program:** Corporate donations to this “No Child Left Behind” program made in 2006 would be subject to a more liberal limitation as a percentage of the corporation’s taxable income.

Higher penalties, new anti-abuse rules, and other changes for exempt organizations

- **New annual reporting requirements for entities other than religious organizations that are exempt from Form 990 reporting requirements:** Under this provision, organizations currently exempt from the annual Form 990 filing requirement because their gross receipts are normally \$25,000 or less would be required to submit a short form disclosing certain information regarding the organization’s governance and operations. This form would not be required of religious organizations and would not be publicly disclosed.

- **Public disclosure of Form 990-T and UBIT certification for large organizations:** Forms 990-T would be disclosed publicly, and organizations with total annual gross revenues or gross assets of at least \$10 million would be required to include with Form 990 or 990-T an independent auditor’s certification that income is correctly reported and expense allocations between exempt and unrelated activities comply with applicable rules. The auditor would also be required to certify whether he or she has reviewed or provided a tax opinion for the organization on a UBIT issue.

- **Modification of UBIT rule on income from controlled entities:** The legislation would modify Section 512(b)(13) to exclude from unrelated business taxable income interest, rents, royalties, and annuities paid by “controlled” entities to their parent exempt organizations as long as the amounts paid do not exceed fair market value. Any amounts in excess of fair market value are subject to UBIT and a 20% valuation misstatement penalty.

- **Increase in various excise taxes for public charities and private foundations:** Excise taxes for violations of private foundation rules would be doubled, except for a self-dealing violation involving the payment of compensation to disqualified persons, in which case the excise tax would be increased from 5% to 25%. The proposal also increases the dollar limitations on the amounts of private foundation excise taxes and the dollar limitation applicable to excise taxes imposed on managers of public charities for excess benefit transactions.

- **Expansion of excise tax based on private foundation net investment income:** “Gross investment income” for purposes of the Section 4940 excise tax would be expanded to include income from notional principal contracts, annuities, and other substantially similar income from ordinary and routine investments.

- **Grants from private foundations to supporting organizations:** The proposal would prohibit non-operating private foundations from including amounts paid to supporting

organizations as “qualifying distributions,” and treat any such payments as taxable expenditures unless the foundation exercises expenditure responsibility.

- **Extension of tax shelter reporting and penalty rules to exempt organizations:**

Exempt organizations that participate in prohibited tax shelter transactions (either to shelter income or as an “accommodation party” in exchange for a fee from a third party) would be subject to additional reporting requirements and excise taxes.

- **Tax on certain “charity-owned” life insurance policies in which the insured party is a substantial contributor:** Life insurance and similar policies in which an exempt organization and a third party hold an interest and the insured party is a substantial contributor would be subject to a prohibitive excise tax.

Donor-advised funds and supporting organizations

- **Donor advised funds:** The proposal would define terms including donor advised fund (“DAF”) and would impose several new requirements on DAFs and “sponsoring organizations” that maintain such funds, including the following:

- Sponsoring organizations would be subject to an annual distribution requirement of at least 5% of the aggregate asset value of DAFs held in the immediately preceding year. The payout requirement would be phased in for existing organizations, with 3% required in the first taxable year after enactment, 4% in the second year and 5% in the third year.

- Each DAF held by a sponsoring organization would be required to distribute over a rolling three-year period the greater of \$250 or 2½% of the sponsoring organization’s required minimum initial contribution amount.

- For DAFs holding assets other than cash and marketable securities (*i.e.*, “illiquid assets”) equal to more than 10% of the total value of assets in the fund, the fund would be required, after a phase-in period, to distribute at least 5% of the value of the assets in the fund at the end of the preceding year.

- A first-tier excise tax of 30% of the undistributed amount would be imposed in the case of a failure to meet any of the above distribution requirements. The tax could be abated if the failure was due to reasonable cause and not willful neglect. If the failure to distribute is not corrected within a certain period of time, a second-tier 100% tax would be imposed.

- The proposal would prohibit distributions to donors or donor advisors and would provide that donors, donor advisors, and investment advisors to DAFs (as well as family members of these individuals) would be treated as disqualified persons with respect to the sponsoring organization for purposes of the intermediate sanctions rules. The proposal also would impose penalties in instances where a donor or donor advisor receives a benefit that is “more than incidental.”

- The proposal would impose additional reporting and disclosure requirements on sponsoring organizations, and would require written acknowledgments provided by sponsoring organizations to donors to state that the sponsoring organization has exclusive legal control over the assets contributed.

- **New restrictions on supporting organizations:** The bill would (1) impose “intermediate sanctions” excise taxes for certain payments to disqualified persons; (2) institute

excess business holdings rules (limiting ownership in certain corporations) for all Type III supporting organizations and certain Type I and II supporting organizations; and (3) include on the annual Form 990 certain disclosure requirements about relationships with supported organizations.

- **Special restrictions on “Type III” supporting organizations:** The bill would (1) prohibit supporting more than five organizations or any organization not formed in the U.S.; (2) prohibit grants to DAFs; (3) impose additional requirements on the exemption application and annual Form 990; (4) impose certain minimum annual distribution requirements; and (5) provide that charitable trusts must demonstrate that they have a close and continuous relationship with the supported organization.

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