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New Foundation and Charity Rules

Major new charitable organization rules in a Pension Act? In this case, yes -- the Pension Protection Act of 2006 (the "Act"), recently signed by President Bush, changes a number of Internal Revenue Code provisions governing charitable organizations and their donors. This Alert briefly describes four of the changes that may be of the most interest to our clients and other friends.

Gifts of Fractional Interests. Donors have often made gifts of a partial interest in a piece of art to a museum (for example, a one-third interest) with the intent of retaining the art for a portion of the year and permitting the museum to display the art for a specific period of time, while receiving an immediate deduction for a pro rata portion of the value. The donor might continue making additional fractional gifts to the museum in future years (or on death), until the museum holds 100% of the property. Although donors may still make fractional gifts, the Act has imposed significant limitations that make it inadvisable to use this technique without further clarification:

1. A donor (or the donor and the donee charitable organization, collectively) must hold 100% of the interest in the donated property immediately before the transfer. If any other party owns an interest in the property, the charitable deduction will be disallowed.
2. Subsequent fractional interest gifts must be valued at the lesser of (a) the value at the time of the initial fractional interest gift, or (b) the value at the time of the subsequent gift. Thus, appreciation after the initial gift is ignored. Gifts made prior to the Act are disregarded for this purpose; the first gift of a fractional interest made after enactment of the Act will be treated as the initial gift.
3. A donor's deduction will be recaptured if the donor does not contribute the entire property interest to the donee charitable organization within 10 years after the initial gift (or before the donor's death, if earlier). The IRS will also recapture deductions for any period after the initial gift of an interest during which the charitable organization does not have "substantial physical possession of the property" or is not using the property for its exempt purpose. The Act further imposes a 10% tax on the amount of any recapture, as well as interest on any recaptured taxes.

Increased Penalties for Valuation Errors. The Act makes changes that significantly increase the likelihood that the 20% and 40% valuation misstatement penalties of Code Section 6662 will be triggered when a charitable deduction is claimed for income tax purposes. A 20% penalty was previously imposed if a claimed deduction was 200% or more of the actual value of the donated property, but this threshold has been reduced to 150%. A 40% penalty is imposed if a taxpayer makes a gross valuation misstatement, and the Act lowers the threshold at which a gross misstatement occurs. For income tax purposes, a gross misstatement is 200% or more (rather than the previous 400%) of the actual value of the property.

In addition, the reasonable cause exception for the gross misstatement penalty has been eliminated. The Act also adds a new provision which imposes a penalty on appraisers whose appraisals result in substantial or gross valuation misstatements.

Increased Excise Taxes. The Act increases certain excise tax rates imposed on private foundations, public charities, and social welfare organizations. Specifically, Congress has doubled the tax rates of Code Sections 4941-4945 which apply to self dealing, minimum income distributions, excess business holdings, jeopardy investments, and taxable expenditures of private foundations. Additionally, the taxes on foundation managers have doubled. For example, for instances of self dealing, the excise tax on a foundation has increased from 5% to 10%, the excise tax on any manager knowingly permitting the transaction has increased from 2.5% to 5%, and the limitation on manager liability has increased from \$10,000 to \$20,000.

Excise tax rates imposed on public charities and social welfare organizations for engaging in excess benefit transactions have not changed, but the liability of an organization manager has been doubled to \$20,000 per excess benefit transaction.

Excise Taxes Imposed on Donor-Advised Funds and Supporting Organizations. The Act imposes new excise taxes on donor-advised funds and supporting organizations. Donor-advised funds are separate accounts identified by the donor family's name with a larger organization, such as a communities foundation, that qualify as a public charity. A supporting organization is a tax-exempt corporation or trust that receives public charity status from its close connection to a separate public charity. These organizations have been useful in the past because they offer somewhat more independence and control than a gift to a public charity with conditions, and entitle the donors to better treatment of contributions and less regulation than a private foundation. However, Congress has expressed concern that these types of organizations have been used to avoid proper regulation, and several provisions in the Act are aimed at limiting their advantages over a private foundation.

Excise taxes are imposed on "taxable distributions" made by donor-advised funds, which include any distribution (1) to an individual, (2) that is not for charitable purposes, or (3) over which the sponsoring organization does not exercise expenditure responsibility. A 20% excise tax is imposed on the sponsoring organization, and a 5% tax is imposed on any fund manager who knowingly agrees to the distribution.

In addition, the excess business holdings rules are now applicable to donor-advised funds and certain supporting organizations, limiting the benefits of these organizations to many entrepreneurs and family-business owners. Contributions of closely held business interests to these organizations may result in excise taxes and, like private foundations, disposition of such interests will be required within a limited time period.

The Act further imposes a 25% excise tax on excess benefit transactions (grant, loan, compensation, or other similar payment) between a donor-advised fund or supporting organization and certain individuals.

Finally, distributions from a private foundation to a donor-advised fund or certain supporting organizations will no longer be treated as tax-free distributions that satisfy the minimum distribution rules of Code Section 4942.

Many supporting organizations are considering whether to apply to the IRS to change their status and seek qualification as a “stand-alone” public charity, in order to avoid application of these restrictions and penalties. Recently, the IRS issued a notice providing the rules and procedures for such a conversion.

If you have any questions about the Act and the impact these changes may have on you or your charitable organization, please contact any of the following attorneys:

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