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THE Good Advisor

A Brief Guide to Charitable Organizations after the Pension Protection Act of 2006

As the popularity of planned gifts continues to rise, more professional advisors are dealing with various forms of charitable organizations including private foundations, community foundations, supporting foundations, and donor advised funds. However, the law concerning the deductibility of contributions to these types of charitable organizations can be complex – even more so since the enactment of the Pension Protection Act of 2006. As a result of these changes, your charitably-minded clients may be asking for clarification on the status of various charitable organizations.

TAX-EXEMPT ORGANIZATIONS

There is a misconception that a tax-exempt organization is the same as a "qualified" charitable organization. Many organizations are tax-exempt under IRC Sec. 501(c), but only certain charitable organizations are "qualified" under IRC Sec. 170(b)(1)(A) and 170(c) so that the donor can claim a charitable deduction for donations.

Most "qualified" charities will be classified as Sec. 501(c)(3) organizations. A Sec. 501(c)(3) organization must meet a three-pronged test:

- The organization must be formed for the purposes of advancing: religion, charity, science, testing for public safety, literature, education, national or international sports competition (if no portion goes to athletic facilities or equipment), or the prevention of cruelty to children or animals
- The organization may not devote a substantial part of its activities to lobbying or participating in political campaigns
- The organization's activities cannot inure to the personal benefit of any member

QUALIFIED CHARITABLE ORGANIZATIONS

Each federal tax – income, gift and estate tax – has its own list of qualifying types of organizations, which are similar but not identical. Permissible donee organizations for income tax purposes under IRC 170(c) include:

- A State, a possession or political subdivision of the United States, or the United States itself (but only if the contribution to any of these entities is made exclusively for public purposes)
- A domestic corporation, trust, or community fund created by a governmental unit described above, or otherwise organized and operated exclusively for purposes of: religion, charity, science, literature, education, amateur sports competition, or the prevention of cruelty to animals or children
- A domestic post or organization for war veterans
- A domestic fraternal society, order, or association if operating as a lodge system for the purposes listed under the second bullet
- A non-profit cemetery company

To qualify for exemption as a charity, an organization must be organized and operated exclusively for one or more exempt charitable purposes.

Charities "qualified" for gift and estate tax purposes under IRC Sec. 2522 and 2055 mirror the income tax list, with some minor differences. For example, an estate and gift tax deduction is not permitted for a donation to a cemetery corporation, but a deduction may be allowed for a donation to a charity that is not a domestic organization.

Verification of an organization's public charity status can be made by consulting the IRS Publication 78 which can be accessed on the Internet at www.irs.gov. This publication lists all organizations that qualify for the income tax charitable deduction. Also, a more direct way to verify the "public charity status" of an organization is to request a copy of the charity's determination letter or a written assurance of its status.

CONTRIBUTIONS TO QUALIFIED CHARITIES

The amount an individual may take as an income tax charitable deduction depends on different factors, including the donee organization and the type of property given.

50% organizations and 30% organizations are the two types of qualified charities. Gifts of cash to 50% organizations can be deducted up to 50% of the donor's Adjusted Gross Income ("AGI"). This category includes organizations that receive a significant number of their funds from the government or the general public [IRC Sec. 170(b)(1)(A)]. A 30% organization is any other type of qualified charity. Gifts of cash to 30% organizations can be deducted up to 30% of the donor's AGI.

Percentage limitations based on the type of property are applied after the amount of the contribution has been determined. A gift of cash to a 50% organization is deductible in the tax year of the contribution up to 50% of the donor's AGI. On the other hand, an appreciated asset that would have produced long-term capital gain if sold on the date of the contribution is only deductible up to 30% of AGI.

In the case of a 30% organization, contributions are limited to 30% of AGI for gifts of cash, and 20% of AGI for gifts of appreciated property. However, it should be noted that any deduction to the 30% organization may be limited by current contributions made to 50% organizations (at full value).

When a limitation is imposed on the amount an individual takes as an income tax charitable deduction in a certain year, the excess amount is not necessarily lost. Instead, any excess deduction above the limitation may be carried over and deducted in up to five succeeding tax years.

NEW RULES UNDER THE PPA FOR CERTAIN QUALIFIED CHARITIES

The Pension Protection Act of 2006 ("PPA") features several reforms and disincentives aimed at private foundations, supporting organizations and donor-advised funds. Here is a survey of these basic types of qualified charities.

Private Foundations appeal to donors who want to retain more control over their charitable donations. A private foundation is defined by default in the Internal Revenue Code. The Code says private foundations are all 501(c)(3) organizations which are not:

- Organizations in which a donor can deduct 50% of his adjusted gross income for cash gifts (i.e. churches, hospitals, governmental units, etc.)
- Organizations with a broad base of public support (organizations which receive over 1/3 of their annual support from members and the general public and not more than 1/3 from unrelated business income and gross investment income)
- Organizations operated, supervised or controlled by a public charity
- Organizations operated for testing public safety

A donation to a private foundation limits the donor to a charitable tax deduction of 30% of the donor's AGI for cash gifts (20% for appreciated property). However, there are three types of private foundations that do allow the donor to claim a 50%-of-AGI deduction for cash gifts – private operating foundations, pass-through foundations, and common fund foundations [Reg. Sec. 1.170A(9)(f), (g)(1)(i), (h)(1)].

Additionaly, a gift of qualified appreciated stock to a private foundation is more advantageous than the usual appreciated property gift: the donor can deduct the full fair market value of qualified appreciated stock rather than cost basis [IRC Sec. 170(e)(5)].

A variety of excise taxes may be imposed on the foundation if it engages in prohibited transactions or fails to maintain required levels of charitable expenditures. Restrictions include prohibitions against:

- Self-dealing between foundations and their contributors [IRC Sec. 4941]
- Failure to distribute at least a minimum amount of the foundation's income for exempt purposes [IRC Sec. 4942]
- Holding business enterprises in excess of specified maximum ceilings [IRC Sec. 4943]
- Investments that jeopardize its tax-exempt status [IRC Sec. 4944]
- Expenditures for lobbying [IRC Sec. 4945].

The PPA significantly increased the excise taxes levied for prohibited transactions (including, but not limited to):

- The excise tax on self-dealing by a private foundation to a disqualified person have been doubled to 10%, and the tax on the foundation manager that approved the improper distribution increased to 5%
- The excise tax on a failure to distribute income by a private foundation is increased to 30%
- The excise tax on both the foundation and the manager for engaging in jeopardizing investments is increased to 10%
- The excise tax on the foundation for excess business holdings is increased to 10%

Furthermore, the PPA has expanded the tax base for a private foundation's investment income to include the income from notional principal contracts, annuities, other ordinary and routine investments, plus the capital gains from the sale or disposition of assets used to further an exempt purpose.

Community Foundations are qualified charities that provide a wide variety of services, including funding community programs and initiatives. Under the cover of a single community foundation, many funds and accounts operate as a single entity with the common goal of promoting a long-term benefit or defined geographic area rather than a series of separate private foundations. Donors are attracted to community foundations because they offer many of the same benefits as private foundations, without many of the drawbacks. For instance, community foundations offer the donor:

- The opportunity to deduct up to 50% of AGI on a cash transfer, and up to 30% of AGI for gifts of long-term appreciated assets
- The chance to deduct the full fair market value for gifts of appreciated property, including closely-held securities
- The assistance of staff to help choose the best cause or object for a gift
- Less start-up costs in terms of time and money as compared to establishing a private foundation
- No requirement to apply to the IRS for tax-exempt status as compared to establishing a private foundation

A donor that makes a contribution to a community foundation can make a gift to a particular fund:

- An unrestricted fund
- A designated fund that restricts distributions to qualified charities as named by the donor
- A field of interest fund that permits the community foundation to make distributions to any qualified charity carrying on a particular sort of work
- A donor advised fund that allows the donor the ability to suggest ways the foundation might make distributions

Donor Advised Funds ("DAFs") have become especially popular in recent years. Typically, the donor makes a donation, and later provides some thought on how he or she wants it distributed. The donor's instruction must only be advisory and may not place "material restrictions" on its distribution. A DAF will be treated as a private foundation if the donor retains legal control over the amounts transferred to the organization.

The PPA has newly defined DAFs for tax purposes. Under a three part definition, a DAF means a fund:

- Separately identifiable by contributions of a donor or group of donors
- Owned and controlled by a sponsoring organization only
- Provides the donor or person designated by donor advisory privileges with respect to distributions or investment in the fund.

Under Sec. 1234 of the PPA, in order for a contribution to a DAF to be deductible for income, gift and estate taxes, the donor must obtain a contemporaneous written acknowledgement from the sponsoring organization stating that the organization "has exclusive legal control over the assets contributed."

Furthermore, the new PPA imposes excise taxes on DAFs to ensure that the sponsoring organizations adopt policies to guard against improper distributions. The following is a summary of the major areas of improper distributions.

Taxable Distributions: Distributions to any individual for any purpose or a distribution not made for charitable purposes are improper and are taxable. The PPA imposes a 20% excise tax to the supporting organization and 5% on the fund manager who approves the distribution knowing it is a taxable distribution [IRC Sec. 4966].

Incidental Benefits: The PPA prohibits DAFs from making a distribution on the advisor's recommendation that results in more than an incidental benefit. The advisor who recommends the distribution and the recipient of the benefits are levied a tax of 125% for which they are jointly and severally liable. A fund manager may also be assessed a 10% tax if he knowingly approves the prohibited distribution [IRC Sec. 4967].

Excess Benefits: The entire amount of any grant, loan, compensation or other payment from a DAF to a donor or advisor or related party is automatically considered an excess benefit, whether or not any consideration was given for the payment. The family member and the organization manager of the sponsoring organization are subject to excise taxes [IRC Sec. 4958].

Excess Business Holdings: A DAF will be treated as a private foundation if the DAF has business holdings in excess of 20% of voting control of a company, less any amount owned by a disqualified person [IRC Sec. 4943(e)(1)]. A donor, advisor to the fund and any related parties are considered "disqualified persons."

Supporting Organizations are frequently associated with community foundations, but may pair with virtually any public charity. A supporting organization is a Sec. 501(c)(3) organization which supports a public charity as a separate governing body. To be classified as a supporting organization, a Sec. 501(c)(3) charity must meet three requirements under IRC Sec. 509(a)(3):

- The organization must be organized and operated exclusively for one or more public charities
- The organization must not be controlled (directly or indirectly) by one or more disqualified persons defined under IRC Sec. 4946
- The organization must be operated, supervised or controlled by or in connection with the designated public charity it is supporting

Public charities encourage the use of supporting organizations because the latter designate in advance which charities they will support, and the designations are usually permanent. And, donors may prefer a supporting organization to a private foundation because of the greater extent of deducting gifts to a public charity, the greater ease and simplicity of the supporting organization form, and the close (but not too close) proximity to the primary charity.

Under the PPA, supporting organizations have come under greater scrutiny and control:

- The same rules that apply to DAF concerning automatic excess-benefit transactions also apply to supporting organizations
- Contributions to certain Type III supporting organizations by private foundations or donor advised funds are no longer automatically treated as a contribution to a public charity
- A supporting organization must provide greater accountability for its dealings
- The Treasury is required under the PPA to issue regulations on the minimum payout requirements as a percentage of income or assets for Type III supporting organizations
- Furthermore, Type III "non-functionally integrated" supporting organizations are now subject to the excess business holdings of IRC Sec. 4943
- A Type III supporting organization cannot support an organization that is not organized in the United States

New Tax Developments

On January 10, 2007, the IRS issued Notice 2007-7 (2007-5 IRB 395) to provide guidance on many miscellaneous items affected by the Pension Protection Act of 2006. In particular, the Notice addressed questions concerning the qualified charitable distributions (popularly known as the IRA charitable rollover).

In an informative Q and A session, the Notice author addressed many grey areas created by amendments to IRC Sec. 408(d)(8). Here are examples of the more interesting comments:

Question: Is the exclusion for qualified charitable distributions available for distributions from an IRA maintained for a beneficiary [not the original owner – Ed.] if the beneficiary has attained age 70_ before the distribution is made?

Answer: Yes. The exclusion from gross income for qualified charitable distributions is available for distributions from an IRA maintained for the benefit of a beneficiary after the death of the IRA owner if the beneficiary has attained age 70_ before the distribution is made.

Question: Is a check from an IRA made payable to a charitable organization described in Sec. 408(d)(8) and delivered by the IRA owner to the charitable organization a direct payment to such organization?

Answer: Yes. If a check from an IRA is made payable to a charitable organization described in Sec. 408(d)(8) and delivered by the IRA owner to the charitable organization, the payment to the charitable organization will be considered a direct payment by the IRA trustee to the charitable organization for purposes of Sec. 408(d)(8)(B)(i).

Question: What are the tax consequences of a direct payment of an amount from an IRA to a charity where the transaction is intended to satisfy the requirements of Sec. 408(d)(8) but fails to do so?

Answer: If an amount intended to be a qualified charitable distribution is paid to a charitable organization but fails to satisfy the requirements of Sec. 408(d)(8), the amount paid is treated as (1) a distribution from the IRA to the IRA owner that is includible in gross income under the rules of Sec. 408 or 408A, as applicable; and (2) a contribution from the IRA owner to the charitable organization that is subject to the rules under Sec.170 (including the percentage limits of Sec.170(b)).

Question: Will a distribution made directly by the trustee to a Sec. 170(b)(1)(A) organization (as permitted by Sec. 408(d)(8)(B)(i)) be treated as a receipt by the IRA owner under Sec. 4975(d)(9)?

Answer: Yes. The Department of Labor, which has interpretive jurisdiction with respect to Sec. 4975(d), has advised Treasury and the IRS that a distribution made by an IRA trustee directly to a Sec. 170(b)(1)(A) organization (as permitted by Sec. 408(d)(8)(B)(i)) will be treated as a receipt by the IRA owner under Sec. 4975(d)(9), and thus would not constitute a prohibited transaction. This would be true even if the individual for whose benefit the IRA is maintained had an outstanding pledge to the receiving charitable organization [the satisfaction of pledges with a qualified charitable distribution is a real advantage – Ed.].

This newsletter is only for professional advisors and only for their information and discussion. It is intended only to provide general information about charitable gifts and charitable-gift planning. This newsletter is not (1) legal, tax, accounting, or financial advice, (2) any solicitation of legal, tax, accounting, or financial services, (3) any securities or investment advice, or (4) any solicitation of securities or investment advisory services. Each professional must evaluate the tax and financial consequences of each individual situation.

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