COUNCIL on FOUNDATIONS

Summary of Charitable Provisions in H.R. 4

Pension Protection Act of 2006

On August 17, 2006, President Bush signed the *Pension Protection Act of 2006* (H.R. 4) into law. This is a summary of the provisions in the bill that most directly affect grantmakers. It is not a complete summary of the bill, which has numerous other provisions affecting charitable organizations. H.R. 4 passed the House on July 28 by a vote of 279-131 and the Senate on August 3 by a vote of 93-5.

This 11-page summary is divided into six sections:

- IRA Charitable Rollover
- Increases in Penalty Excise Taxes
- Expansion of the Base for the Private Foundation Tax on Investment Income
- Donor-Advised Funds
- Supporting Organizations
- Application of the Excess Business Holdings Rule to Donor-Advised Funds

IRA Charitable Rollover

Permits persons who have reached 70 ½ to exclude from income of up to $100,000 a year in retirement plan assets if contributed to a qualifying charity. Split-interest gifts and gifts to donor-advised funds, supporting organizations, and private foundations do not qualify for the exclusion.

Effective– Contributions made during 2006 and 2007.

Increases in Penalty Excise Taxes

1. Private Foundations

   Generally doubles the amounts and percentages. The self-dealing tax remains not subject to abatement. However, the self-dealing tax will NOT increase to 25 percent for cases of excessive compensation.

2. Public Charities and Social Welfare Organizations

   Doubles the manager limit (to $20,000) under section 4958.

Effective – Tax years beginning after date of enactment.

Expansion of the Base for the Private Foundation Tax on Investment Income

Expands the base for the tax to include income from sources that are similar to those specifically enumerated in section 4940 and gains from the sale of property used for the production of gross investment income, not just that held to produce interest, dividends, rents and royalties. A new provision will permit private foundations to exclude capital gain from dispositions of exempt use property provided the property has been used for exempt purposes for at least one year if the property is exchanged for like kind property following rules similar to those used in section 1031 ("Starker") exchanges. Note that this provision is dependent on the adoption of regulations to implement it.

Effective – Tax years beginning after date of enactment

Donor-Advised Funds

1. Treasury Department Study. Directs the Secretary of the Treasury to conduct a one-year study to determine:

    - Whether charitable contributions deductions are "appropriate" for gifts to advised funds in light of the use of contributed assets (apparently the issue is retention of contributed assets) and use of assets to benefit the person making the gift or a related person
    - Whether advised funds should be subject to a payout requirement
    - Whether retention of advisory rights is consistent with the treatment of the transfers as completed gifts
    - Whether the preceding issues are issues with respect to other forms of charities or charitable gifts

    Study Due Date – No later than one year from date of enactment

2. Definition of Donor-Advised Fund: Any fund or account:

- Which is separately identified by reference to the contributions of a donor or donors
- Which is owned and controlled by the sponsoring organization; and
- With respect to which a donor or person appointed by the donor has or reasonably expects to have advisory rights with respect to investments or distributions.

3. Exceptions: The term donor-advised fund does not include any fund:

- Which makes distributions to only one identified organization or governmental entity;
- Which makes grants to individuals for travel, study, and similar purposes if:
    - The fund is advised by a committee all of the members of which are appointed by the sponsoring organization and the committee is not controlled by the donor or persons appointed by the donor;
    - Grants are awarded using an objective and nondiscriminatory process approved in advance by the sponsor's board and that meets the requirements for similar grants by private foundations
- Which is exempted by the Secretary of the Treasury provided the fund is either:
    - Advised by a committee not controlled by the donor; or
    - Is a fund benefiting a single charitable purpose

Comment: Funds that make payments directly to individuals for disaster relief or emergency hardship must either avoid classification as donor-advised or obtain an exception from the Internal Revenue Service, although exemption is no longer required to be by regulation. This will not affect funds that make grants to charitable organizations that provide assistance to individuals.

Advised funds maintained by governmental entities and by private foundations are excluded from the new rules.

4. Prohibited Grants

- Grants to individuals
- Grants to any entity if the payment is not for a charitable purpose

Effective – Tax years beginning after date of enactment

5. Grants Requiring the Exercise of Expenditure Responsibility

- Grants to private, nonoperating, foundations (grants to a private foundation established by the donor or his family remain should still be avoided)
- Grants to Type III supporting organizations (except for those that are "functionally integrated") and grants to Type I or II supporting organizations if the donor or advisor controls a supported organization or the Secretary determines by rule that a distribution is inappropriate
- Grants to organizations not described in section 170(b)(1)(A).

Effective – Tax years beginning after date of enactment

5. Permitted Grants

- Grants to any organization described in section 170(b)(1)(A) (other than certain supporting organizations)
- Grants to organizations not described in section 170(b)(1)(A) if expenditure responsibility is exercised
- Grants to the sponsoring charity
- Grants to other donor-advised funds

Comment: International grantmaking from donor-advised assets is permitted using either equivalence determinations or expenditure responsibility.

6. Prohibited Benefits: Penalties apply if the donor, advisor or related parties receive more than incidental benefits from a donor-advised grant. The penalty, which is 125 percent of the amount of the benefit, can be imposed on the person who recommended the grant or the person who received the benefit. Fund managers who approve the grant are subject to a penalty of 10 percent if they knew the distribution would result in the benefit.

Effective – Tax years beginning after date of enactment

Comment: Unlike other comparable penalty excise taxes, there is no requirement that the amount of the benefit be repaid to the charitable organization. Instead, by imposing a 125 percent tax, the drafters have provided for repayment to the government.

7. Excess Benefit Transactions: The legislation bars grants, loans, compensation and similar payments from donor-advised funds to donors, advisors and related parties. Receipt of such payments is automatically an excess benefit transaction subject to penalty under section 4958. Section 4958 imposes a penalty of 25 percent of the amount involved and requires that the amount involved be repaid. In this instance, the amount repaid may not be held in any donor-advised fund.

Effective – **Immediate – Transactions occurring after date of enactment**

Comment: The section on prohibited benefits covers situations in which donors receive benefits from grantee organizations. This section addresses payments made directly from the advised fund. The prohibited benefit penalty will not apply if the section 4958 penalty applies to the same transaction.

8. Investment Advisors: Investment advisors, defined as anyone compensated by the organization for providing investment advice with respect to advised funds, will be subject

to penalties if the compensation paid is excessive. These penalties will apply even if the investment advisor would not otherwise be covered by section 4958 because he or she is not a person of substantial influence with respect to the organization.

Effective – **Immediate – Transactions occurring after date of enactment**

9. Excess Business Holdings Rule: The private foundation excess business holdings rule will apply to assets held by donor-advised funds. How this will work is described in detail at the end of this document. This provision replaces the "illiquid asset" distribution rules that were included in the reform legislation that passed the Senate last November.

10. Requirements Affecting the Charitable Deduction

- Gifts to advised funds at Type III supporting organizations (except those that are functionally integrated).
- Gift acknowledgements to donors must explicitly affirm that the sponsoring organization has exclusive legal control over the contributed assets.

Effective – Gifts made beginning 180 days after date of enactment

11. Reporting Requirements
- Form 990 must include:
  - Total number of donor-advised funds
  - Aggregate assets held by donor-advised funds
  - Aggregate contributions to and distributions by donor-advised funds

Effective – tax returns filed for tax years beginning after date of enactment

- Applications for exempt status (Form 1023) must give notice that the organization intends to maintain donor-advised funds and describe how the organization will maintain such funds.

Effective – date of enactment

12. Distribution Requirements: All distribution requirements have been dropped. Accordingly, there is no five percent aggregate payout requirement nor any fund-by-fund minimum activity rule.

Supporting Organizations

1. Type III Supporting Organizations

   - Must provide such information as the Secretary of the Treasury requires to each supported organization
   - May not support a foreign organization, with a three year transition rule for existing organizations

   Effective – Date of enactment

   Comment: The drafters dropped a provision that would have limited the number of organizations a Type III supporting organization can support

2. Type I and III Supporting Organizations: An organization will fail to qualify as a Type I or III supporting organization if it accepts a gift from a person who directly or indirectly controls a supported organization.

   Effective – Date of enactment

3. Type III Charitable Trusts: The power to enforce the trust will not longer be sufficient to demonstrate that Type III charitable trusts meet the responsiveness test.

   Effective – One year after date of enactment for trusts in existence on the date of enactment; otherwise, date of enactment

4. Type III Payout Requirements: The drafters dropped the mandatory 5 percent payout and substituted this provision, which directs the Secretary of the Treasury to adopt regulations requiring that Type III supporting organizations, other than those that are functionally integrated, distribute a percentage of either income or assets to the supported organizations that is sufficient to ensure that a “significant amount” is paid to the supported organizations.

   Effective – Date of enactment

5. Excess Benefit Transactions – Types I, II, and III:

- Persons who are disqualified persons with respect to a supporting organization will also be disqualified with respect to the supported organization.

Effective – Transactions occurring after date of enactment

- Supporting organizations may not make grants, loans, compensation, or similar payments to the organization's substantial contributor, members of the contributor's family, or businesses they control.
- Supporting organizations may not make loans to any disqualified persons (i.e., foundation managers)
- The above rules do not apply when the substantial contributor or other disqualified person is a public charity.

Effective **– Retroactive – Transactions occurring after July 25, 2006**

6. Excess Business Holdings Rule – Type III Supporting Organizations

- The private foundation excess business holdings rule will apply to Type III supporting organizations unless they are functionally integrated. It will also apply to Type I supporting organizations if the supported organization is controlled by the supporting organization's donors.
- Disqualified person is defined using the more expansive section 4958 definitions in place of the section 4946 definitions that apply to private foundations and includes organizations controlled by the same person or persons who control the supporting organization and organizations which received substantially all of their contributions from the supporting organization's substantial contributor or related parties
- A Type III supporting organization is functionally integrated if it is not required under regulations established by the Secretary to make payments to supported organizations due to its activities related to performing the functions of or carrying out the purposes of the supported organizations.
- The Hershey Trust, and any other Type III supporting organization that held assets as of November 18, 2005 on the direction of a state attorney general or other official with jurisdiction over the organization, is exempt.
- Other Type IIIs may seek an exemption based on a determination by the Secretary of the Treasury that the organization's holdings are consistent with the purpose or function that constitutes the basis for its exemption.
- Disposition of assets held on the date of enactment will follow the transition rules given private foundations in 1969.

Effective – Tax years beginning after date of enactment

7. Grants by Private Foundations to Supporting Organizations: Private nonoperating foundations must exercise expenditure responsibility in making grants to Type III supporting organizations (other than functionally integrated) and to Type I and II supporting organizations if a disqualified person of the private foundation directly or indirectly controls a supported organization or if the Secretary of the Treasury, by regulation, determines that the distribution is inappropriate. These grants are NOT qualifying distributions for purposes of the payout requirement.
   Effective **– Immediate – Applies to distributions and expenditures after date of enactment**

8. Reporting Requirements: The Form 990 for all supporting organizations must list the supported organizations, indicate which type of supporting organization it is, and certify that it is not controlled directly or indirectly by disqualified persons (other than those disqualified solely by being an organization manager).

   Effective – Returns filed after date of enactment

Application of the Excess Business Holdings Rule to Donor-Advised Funds

H.R. 4 makes the private foundation excess business holdings rule applicable to donor-advised funds as if they were private foundations.[1] That is, the holdings of a donor-advised fund, together with the holdings of persons who are disqualified persons with respect to that fund, in a business enterprise may not exceed:

- Twenty percent[2] of the voting stock[3] of an incorporated business; or
- Twenty percent of the profits interest of a partnership or joint venture or the beneficial interest of a trust or similar entity
- Ownership of unincorporated businesses that are not substantially related to the fund's purposes is prohibited

Donor-advised funds receiving gifts of interests in a business enterprise after the date of enactment will have five years to divest holdings that are above the permitted amount, with the possibility of an additional five years if approved by the Secretary of the Treasury. Funds that currently hold such assets will have a much longer period to divest under the same complicated transition relief given to private foundations in 1969.[4]

***Definition of "business enterprise"* –** A "business enterprise" is the active conduct of a trade or business, including any activity which is regularly carried on for the production of income from the sale of goods or the performance of services. Specifically excluded from the definition are:

- Holdings that take the form of bonds or other debt instruments unless they are a disguised form of equity
- Income from dividends, interest, royalties and from the sale of capital assets
- Income from leases unless the income would be taxed as unrelated business income
- "Functionally-related" businesses and program-related investments
- Businesses that derive at least 95 percent of their income from passive sources (dividends, interest, rent, royalties, capital gains). This will have the effect of excluding gifts of interests in most family limited partnerships and other types of holding company arrangements.

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[1] The language is clear that it is only the donor-advised fund, not the sponsoring charity, that is to be treated as a private foundation. Accordingly, I do not think this section affects assets held by the sponsoring charity's investment pools, or assets held by funds that are not donor-advised.

[2] Thirty-five percent if it can be shown that persons who are not disqualified persons have effective control of the business.

[3] Additionally, the DAF will be barred from holding non-voting stock of an incorporated business unless the disqualified persons collectively own less than 20 percent of the voting stock.

[4] Excess holdings acquired by purchase must be disposed of immediately. If purchases by disqualified persons cause the DAF to have excess holdings, the DAF will have 90 days to dispose of the excess.

***Definition of a disqualified person* –** Donors and persons appointed or designated by donors are disqualified persons if they have or reasonably expect to have advisory privileges with respect to the DAF by virtue of their status as donors. Members of donors and advisors families are also disqualified, but the section does not define "family" and does not cross reference either section 4958 or 4946 for the definition. Finally, the term includes 35 percent controlled entities as defined in section 4958(f)(3).

***Impact* –** The new rule will mainly affect contributions of closely-held businesses and in most cases will require the donor-advised fund to dispose of the contributed interest within five years of the date of gift because the disqualified persons will generally own more than 20 percent of the business.[5] The rule will not apply to assets held by the sponsoring charity, as long as they are not held by the donor-advised fund, apparently permitting a sponsoring charity to keep a contributed asset as part of its overall investment portfolio. It will also not apply to gifts to funds, such as field of interest or designated funds, that are not donor-advised.

Because they are not "business enterprises," the rule will not apply to most gifts of real property. The most important exception will be undeveloped land, which may become a business enterprise if the charity that owns it takes extensive steps to subdivide it and prepare it for sale. This is a particularly dangerous situation because this could require immediate divestiture. Interests in investment partnerships and LLCs, including family partnerships, hedge funds, REITs, and so forth are excluded from the definition of business enterprise as long as 95 percent or more of the entity's income is from passive sources. Examples of other property gifts that are excluded because they are not business enterprises include oil and gas interests (non-working), life insurance, tangible personal property (as long as it is not inventory), and remainder interests in personal residences and farms.

***Existing holdings* –** The rules that will apply to DAFs holding business interests on the date of enactment of HR 4 are quite complex. In Phase 1, DAFs that together with their disqualified persons hold more than a combined 50 percent interest in a business will be required to reduce their combined holdings down to 50 percent, and, in most cases the foundation's share of the holdings to 25 percent, in accordance with the following schedule:

- Twenty years if the DAF and disqualified persons collectively own 95 percent or more of the voting or profits interests of a business enterprise
- Fifteen years if the combined total is 75 percent or more, but less than 95 percent
- Ten years if the combined total is more than 50 percent, but less than 75 percent.

[5] Under the *de minimis* rule, the DAF could continue to hold an interest that did not exceed two percent of the voting stock and two percent of the value.

Phase two is the fifteen-year period that begins at the end of phase one. During this period, the combined holdings are limited to 50 percent, but if the disqualified persons' share is two percent or more, the foundation may own no more than 25 percent of the total. At the end of phase two, the combined holdings may not exceed 35 percent and the foundation's share may not be more than 25 percent if the disqualified persons' share is two percent or more. [6]

Effective date **–** Tax years beginning after date of enactment. This will be January 1, 2007 for calendar-year taxpayers. However, the transition rules for existing holdings will apply only to assets held on the date of enactment.

[6] Additional rules apply to cover situations such as mergers, redemptions, and acquisitions.

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