Provisions in the Pension Protection Act Affecting Tax-Exempt Organizations

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Summary

Title XII of the Pension Protection Act of 2006 (H.R. 4) contains a variety of provisions affecting tax-exempt organizations. They include charitable giving incentives for such things as conservation easements, food and book inventory, and charitable distributions from IRAs. The Title also contains provisions relating to oversight, such as tightening the rules for donations of facade easements. It also deals with some specific types of organizations, including credit counseling organizations, donor advised funds, and supporting organizations. President Bush signed the Act into law, P.L. 109-280, on August 17, 2006. This report summarizes the Title's provisions.

Tax-Free Distributions from IRAs for Charitable Purposes

In general, if an individual withdraws funds from a traditional or Roth individual retirement account (IRA) to make a charitable contribution, the transaction is subject to the regular tax rules. The individual is taxed on the withdrawal, unless it qualifies as a tax-free distribution, and may deduct the amount as a charitable contribution, subject to various limitations. Section 1201 of the Act permits tax-free IRA withdrawals if the contribution is made directly to a qualifying charitable organization. The maximum withdrawal per year is $100,000, and the individual must be at least 70½ years old. Tax-free distributions may not be deducted as a charitable contribution, but are treated as includible in income for purposes of IRC § 72. The provision applies to distributions made in taxable years beginning before January 1, 2008. The provision also increases the failure to file penalties on split-interest charitable trusts for returns for taxable years beginning after December 31, 2006.

Food Inventory

In general, donors of food inventory may claim a charitable deduction equal to their basis in the inventory (typically, its cost). C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus 50% of the property's appreciated value or (2) two times basis. The Katrina Emergency Tax Relief Act of 2005 (KETRA, P.L. 109-73) allows all donors of wholesome food inventory to benefit from the enhanced deduction for donations made between August 28, 2005, and January 1, 2006. Section 1202 extends the KETRA provision until January 1, 2008.

Basis Adjustment to Stock of S Corporation

When an S corporation makes a charitable donation, the benefits pass through to its shareholders and each claims a proportionate share of the deduction, which, for donations of certain property, equals the property's fair market value. Each shareholder then reduces his or her basis in the stock by the amount he or she claimed as a deduction. Section 1203 allows shareholders to instead reduce their basis by the proportionate share of their adjusted basis in the donated property. The provision applies for contributions made between December 31, 2005, and January 1, 2008.

Book Inventory

In general, donors of inventory may claim a charitable deduction equal to their basis in the inventory (typically, its cost). KETRA allows C corporations an enhanced deduction for donations of book inventory to public schools if made between August 27, 2005, and January 1, 2006. The corporation may deduct the lesser of (1) basis plus 50% of the property's appreciated value or (2) two times basis. The school must certify that the books are suitable and will be used in its educational program. Section 1204 of the Act extends the KETRA provision through January 1, 2008.

Tax Treatment of Certain Payments to Controlling Exempt Organizations

Tax-exempt organizations are taxed on unrelated business income. Certain types of income, including interest, royalties, and rents, are generally not treated as such income unless received from a subsidiary that is more than 50% controlled by the organization and the payment reduces the subsidiary's income. Under section 1205, the payment is not taxable to the organization to the

extent it reflects the proper allocation of income between the organization and subsidiary. Penalties apply if the amount claimed is incorrect. The payment must be made under an existing contract or renewal and between December 31, 2005, and January 1, 2008.

Contributions for Conservation Purposes

Generally, individuals may not claim a charitable deduction that exceeds 50% of their "contribution base" (adjusted gross income with certain adjustments) and corporations may not claim a deduction that exceeds 10% of their taxable income with certain adjustments. For individuals, the 50% limitation is reduced to 30% for the donation of capital gain property. For both individuals and corporations, excess contributions may be carried forward for five years. Section 1206 increases the 30% limitation to 50% and the carryforward period to 15 years for qualified conservation contributions. For farmers and ranchers, including qualifying corporations, the limitation percentage is increased to 100%. The provision applies to contributions made between December 31, 2005, and January 1, 2008.

Blood Collector Organizations

The American Red Cross is exempt from various excise taxes. Section 1207 provides an exemption under certain circumstances for any qualified blood collector organization from certain excise taxes: special fuels tax, manufacturers excise tax, communications excise tax, and the tax on heavy vehicles. The provision becomes effective on January 1, 2007.

Insurance Contract Reporting

Section 1211 imposes a new reporting requirement on some tax-exempt entities that acquire an interest in certain insurance contracts if the acquisition is part of a structured transaction involving a pool of contracts. The rule generally applies to any life insurance, annuity, or endowment contract in which the organization and another person have held, directly or indirectly, an interest. The requirement applies to acquisitions occurring before August 17, 2008.

Increase Penalties on Tax-Exempt Organizations

Tax-exempt organizations and their managers are penalized if they engage in certain activities. An additional penalty tax applies if the activity is not corrected. Section 1212 doubles the initial taxes applicable to private foundations and managers for self-dealing, failing to distribute income, having excess business holdings, having investments that jeopardize charitable purpose, and making taxable expenditures. For some, the maximum additional tax on managers is doubled as well. The section also doubles the maximum initial tax on managers of IRC §§ 501(c)(3) and (c)(4) organizations for engaging in excess benefit transactions. The provision is effective for taxable years beginning after August 17, 2006.

Facade Easements

Donors may deduct charitable contributions of an interest in real property that is exclusively for conservation purposes, including the preservation of a certified historic structure. The contribution may be a permanent restriction on the property's use, such as a facade easement. Section 1213 creates additional requirements for donations of facade easements. Among other

things, the restriction must preserve the entire exterior of the building and prohibit any change inconsistent with its historical character; the donee and donor must enter into a written agreement certifying that the donee has the resources and commitment to manage and enforce the restriction, and the donor must include with the tax return an appraisal, pictures of the property, description of the restriction, and $500 fee for deductions exceeding $10,000. The deduction is reduced to reflect any rehabilitation credits claimed for the property during the preceding five years. The section generally applies to contributions made after July 25, 2006.

Taxidermy Contributions

Generally, the charitable contribution deduction for donations of property is the property's fair market value, but it is reduced to basis for certain types of contributions. Section 1214 reduces the deduction for contributions of taxidermy property to the cost of preparing, stuffing, or mounting the animal if made by the person who prepared, stuffed, or mounted the animal or paid for it. It applies to contributions made after July 25, 2006.

Donations Not Used for an Exempt Use

The charitable contribution deduction for donations of property is generally the property's fair market value. It is reduced to the donor's basis for certain contributions, including those of tangible personal property used by the donee in a manner unrelated to its exempt purpose. Under section 1215, if the donee sells or disposes of tangible personal property with a claimed value of at least $5,000 in the year of contribution, the deduction is limited to the taxpayer's basis; if the sale or disposition happens within the next two years, the donor must include as income the amount that the claimed deduction exceeded the taxpayer's basis in the property. The rules do not apply if the organization reports to the IRS that the donation was exempt use property when contributed but it later became impossible or unfeasible to actually use it as such. There is a $10,000 penalty for stating property is exempt use property while knowing it was not intended for such use. The section generally applies to returns filed after September 1, 2006.

Donations of Clothing and Household Items

In general, taxpayers donating used clothing and household items may deduct the property's fair market value. Section 1216 disallows a deduction unless the property is in good used condition. A deduction may be claimed for an item that is not in such condition if the claimed deduction is more than $500 and a qualified appraisal is provided to the IRS. The section also authorizes the IRS to promulgate regulations that disallow a deduction for donations of items of minimal value. The section applies to contributions made after August 17, 2006.

Modify Recordkeeping and Substantiation Requirements

Donors are required to keep reliable written records of their charitable contributions. For contributions of at least $250 in value, the donor must obtain a contemporaneous written acknowledgment from the organization. Additional requirements apply if the contribution is of high-value property. Section 1217 requires donors making cash donations maintain a bank record or written communication from the organization showing its name and the date and amount of the contribution. The provision applies to contributions made in taxable years beginning after August 17, 2006.

Contributions of Fractional Interest in Tangible Personal Property

Under certain circumstances, donors may deduct a charitable contribution of a fractional interest in tangible personal property and later make additional deductible contributions of interests in the same property. Under section 1218, for income, estate, and gift tax purposes, the property's value for determining the additional contribution's deduction is the lesser of the value used for determining the initial deduction or the property's fair market value at the time of the additional contribution. The section also requires the Treasury Secretary to provide for the recapture of a deduction allowed for income or gift tax purposes if (1) the donor does not contribute the remaining interest to the donee within 10 years of the initial contribution or by the donor's death, whichever is earlier, or (2) the donee did not have substantial physical possession of the property and use it for an exempt purpose during the 10 years after the initial contribution or before the donor's death, whichever is earlier. There is a penalty equal to 10% of the recaptured amount. The section applies to contributions, bequests, and gifts made after August 17, 2006.

Accuracy-Related Penalties

Taxpayers are penalized for substantial valuation misstatements and substantial estate or gift tax valuation understatements. An increased penalty applies for gross valuation misstatements and gross estate or gift tax valuation understatements. Section 1219 redefines substantial and gross misstatements and understatements to make the penalties apply to more misstatements and understatements, and eliminates the reasonable cause exception for gross valuation misstatements. The section also defines "qualified appraiser" in IRC § 170, authorizes disciplinary actions against appraisers, and penalizes those knowingly involved in valuation misstatements. The section generally applies to returns filed after August 17, 2006.

Credit Counseling Organizations

Credit counseling organizations may qualify for tax-exempt status under IRC § 501(c)(3) or (c)(4). Section 1220 imposes additional requirements on these organizations with tax-exempt status. Among other things, the organization must provide services tailored to consumers, not make loans to or negotiate on behalf of debtors, and provide only incidental services relating to improving the consumer's credit history and not charge separate fees for them. The organization cannot refuse to provide services because the consumer cannot pay or does not enroll in a debt management plan. The organization must ensure that fees are reasonable, will be waived if the consumer cannot pay, and are not based on the consumer's debt or savings from using the services, except as provided by state law. The organization must also have a diverse board of directors. Organizations that are exempt under IRC § 501(c)(3) cannot solicit contributions from current consumers and face limits on their income from debt management plan services. Organizations exempt under IRC § 501(c)(4) must notify the IRS they are applying for recognition as a credit counseling organization. The provisions are generally effective for taxable years beginning after August 17, 2006.

Net Investment Income

Private foundations are subject to tax on their net investment income. Among other things, section 1221 expands the base used to compute the tax to include income from items similar to those already listed. The provision is effective for taxable years beginning after August 17, 2006.

Definition of Convention or Association of Churches

Conventions and association of churches are generally subject to the same tax laws as churches. Section 1222 provides that an organization will not fail to qualify as a convention or association merely because its has individuals as members or with voting rights.

Notification Requirement

Some tax-exempt organizations are not required to file annual information returns (Form 990), including organizations with gross receipts below $25,000. Section 1223 requires that these small organizations electronically report to the IRS each year their name, mailing and Internet addresses, taxpayer identification number, principal officer's name and address, and evidence that its gross receipts are below the threshold. An organization that fails to provide the information for three consecutive years loses its tax-exempt status and must apply to the IRS for reinstatement. If the organization shows reasonable cause for the failure, its status may be reinstated retroactively. The section applies to periods beginning after 2006.

Disclosure to State Officials

Under certain circumstances, the IRS is authorized to disclose some information about IRC § 501(c)(3) organizations to state officials, including a refusal to recognize an organization, a revocation of tax-exempt status, and the mailing of tax deficiency notice. Section 1224 extends this to include notices of proposed refusal, revocation or deficiency, identifying information of organizations that have applied for IRC § 501(c)(3) status, and the returns and return information of such organizations. It also allows disclosure under certain circumstances of information relating to other IRC § 501(c) organizations. The section is effective on August 17, 2006.

Unrelated Business Income Tax Returns

Tax-exempt organizations must generally make public their applications for tax-exempt status and annual information returns. Section 1225 of the Act extends the disclosure and penalty requirements to the unrelated business income tax returns of IRC § 501(c)(3) organizations. The section applies to returns filed after August 17, 2006.

Donor Advised Funds

Normally, if donors can direct funds to a specific recipient, they are not entitled to a charitable contribution deduction. Donor advised funds (DAFs) are charitable accounts set up and sponsored by an organization to which donors contribute and provide advice on the account's distributions and investments, although the sponsoring organization must have final say on the actual distributions and investments. There is no mention of DAFs in the tax code, but the IRS has allowed the sponsoring organizations to qualify for exempt status under IRC § 501(c)(3). Section 1226 requires the Treasury Secretary to study DAFs and type III supporting organizations (discussed below) to look at whether it is appropriate to allow a charitable contribution deduction for contributions to the fund's sponsoring organization or the type III supporting organization.

Section 1231 imposes a penalty tax on certain distributions made from a DAF to a natural person, for a non-charitable purpose, or without the sponsoring organization maintaining expenditure

responsibility. The tax on the sponsoring organization is 20% of the distribution, and the fund manager may be subject to a 5% penalty, limited to $10,000. The section also imposes a tax if a person advises the sponsoring organization to make a distribution from a DAF and that person, or a related person or entity, receives more than an incidental benefit. The tax on the person who gave the advice or received the benefit is 125% of the benefit, and the fund manager may also be subject to a 10% tax, limited to $10,000. Section 1232 applies the penalty tax on excess benefit transactions to DAFs and adds DAF donors to the list of disqualified persons. Section 1233 subjects DAFs to the penalty tax on private foundations for excess business holdings. Section 1234 requires that for a contribution to a DAF to be deductible for income, estate, and gift tax purposes, the taxpayer must obtain a contemporaneous written acknowledgment from the sponsoring organization that certifies it has legal control over the contribution. Section 1235 requires the sponsoring organization to include information about the DAFs it owns on its annual information return. The section also requires that the sponsoring organization indicate on its application for tax-exempt status that it intends to maintain DAFs and how it plans to operate them. These provisions are generally effective for taxable years beginning after August 17, 2006.

Type III Supporting Organizations

Supporting organizations are a type of IRC § 501(c)(3) organization. They must (1) be organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of at least one public charity; (2) be operated, supervised, or controlled by or in connection with at least one public charity; and (3) not be controlled by a disqualified person. To satisfy the second test, the organization must be either (1) operated, supervised, or controlled by the supported organization; (2) supervised or controlled in connection with the supported organization; or (3) operated in connection with the supported organization.

Under section 1241, type III supporting organizations may only support U.S. organizations and must provide information, as required by the IRS, to that organization to ensure that the supporting organization is responsive to its needs and demands. It also restricts type I and III supporting organizations from accepting gifts or contributions from a person who controls the supported organization and related persons or entities. It requires the Treasury Secretary to promulgate regulations to require that type III supporting organizations that are not functionally integrated to the supported organization annually distribute a significant amount of assets or income to the supported organization. Section 1242, among other things, imposes the tax on excess benefit transactions on certain payments made by a supporting organization to a substantial contributor or related person or entity. Section 1243 makes supporting organizations subject to the penalty tax on excess business holdings. Section 1244 limits the circumstances in which a private foundation may treat a distribution to a supporting organization as counting toward the amount that the foundation must distribute each year. Section 1245 requires that a supporting organization include on its annual information return what type they are, a list of supported organizations, and certification they are not controlled by a disqualified person. The provisions are generally effective on, or for taxable years beginning on or after, August 17, 2006.

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