

Legal Update: Charity Reforms and Other Developments

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Pension Protection Act Purposes

- Purpose of the Act is to encourage charitable contributions, tighten reporting and reform charitable operations where there were perceived abuses
- Two major areas of reform:
 - Donor reporting and deductions
 - Charity reporting and operations

Checklist of donor reporting and deduction reforms



- Trade or business food inventory deductions enhanced through 2007
- S Corporation contributions reduce shareholder basis only by pro rata adjusted basis of contributed property through 2007
- Donated taxidermy property deduction is lesser of basis or fair market value

Checklist of donor reporting and deduction reforms (cont.)



- Raises charitable deduction limit to 50% of AGI (from 30%) for qualified conservation easement contributions, as long as it does not prevent the use of the land for farming or ranching (100% limit of AGI for eligible farmers and ranchers); carryover allowed for 15 years; through 2007

Checklist of donor reporting and deduction reforms (cont.)



- Clarifies façade easements in historic districts and clarifies that the charitable deduction is reduced if a rehabilitation tax credit has been claimed for the property
- Adds public schools to list of eligible donees of book inventory by C Corporations through 2007

Checklist of donor reporting and deduction reforms (cont.)



- Prohibits deductions for contributions of clothing and household items unless they are in good or better used condition
- Requires that for contributions of money, donors must retain substantiation documentation
- Allows rollovers of IRAs to qualified charities through 2007

Checklist of donor reporting and deduction reforms (cont.)



- Deductions for partial interests in property are significantly limited
- Deductions for property not used for exempt purposes are recaptured
- Increases tax penalties for deductions where qualified appraisals are required

Donations of clothing and household goods

- To obtain deduction, items must be in good or better used condition
- No definition of “good” is provided
- Household items does not include: food, paintings, antiques, objects of art, jewelry, gems and collectibles
- Exception for single appraised items more than \$500

Cash or money distributions

- No deduction allowed without proper substantiation
- No limitation on value or amount
- Donor must be able to show check, bank statement or receipt from charity showing amount, date and charity name
- No exceptions, no mercy
- Will increase charity's time in receipting for gifts

Tax Free IRA Distributions for Charity



- Effective for qualified charitable distributions through 2007
- Qualified charitable distributions are excluded from gross income
- Qualified charitable distribution only to §170(b)(1)(A) organizations other than donor advised funds, private foundations or supporting organizations

Tax Free IRA Distributions for Charity (cont.)



- Requirements:
 - Individual at least 70 ½
 - Traditional or Roth IRA
 - Distribution would have been taxable
 - Up to \$100,000 per year
 - Deduction would otherwise have been available (substantiation applies)
 - Direct payment to qualified charity outright, not charitable lead or remainder trusts, pooled income funds or gift annuities

Tax Free IRA Distributions for Charity (cont.)



- Typical taxpayer affected
 - Does not itemize
 - May not be able to deduct the entire contribution due to the 50% of AGI limitation
 - Has high enough income that exemptions, deductions and credits are otherwise phased out
 - Has modest income so adding income would increase taxability of their Social Security
 - Resides in states where charitable contributions are not deductible for state income tax purposes

Recapture for property not used for exempt purpose

- Effective for contributions made after 9/1/2006
- General rule is that taxpayers are entitled to a deduction for the built-in capital gain when donating appreciated tangible personal property only if it is used for the charity's exempt purposes
- Actual use or excuse required – what about storage?

Recapture for property not used for exempt purpose (cont.)

- New rules affect donations of appreciated property where FMV deduction greater than \$5,000
- If charity disposes of property within 3 years after donation, donor must include in income the difference between the FMV and basis
- Disposition probably includes exchange with another charity even though it may use the item for its exempt purpose

Recapture for property not used for exempt purpose (cont.)



- Exception if charity certifies how property used for exempt purpose and/or that intended use has become impossible or unfeasible
- \$10,000 penalty for certification of exempt purpose where person certifying knows no intended exempt use
- Form 8282 used to report disposition within three years and factors supporting exempt use

Recapture for property not used for exempt purpose (cont.)



- Recommend that future gifts be made with formal deeds of gift stating condition that items be used primarily for exempt related purposes

Partial Interests in Donated Property



- Effective for gifts and transfers after 8/17/2006
- No deduction allowed for gift of fractional interest in property unless requirements met
- Prior law allowed partial interests in the form of “vertical slices” to be donated as long as the charity was entitled to pro rata possession

Partial Interests in Donated Property (cont)

- New rules change the old rules drastically
- Rules are so onerous they will likely discourage donors from making donations of fractional interests in property, which could present an impact to museums and historical organizations
- Commentators advise against making these types of gifts in this climate

Partial Interests in Donated Property (cont.)

- Requirements:
 - Immediately prior to donation, all interests must be owned (1) by the donor or (2) by the donor and the donee charity. Exceptions may be made by the IRS for pro rata contributions by all owners
 - If there are co-owners, this likely means that both must give or none can give, unless regulations change this

Partial Interests in Donated Property (cont.)

- Recapture of deductions required where donor fails to contribute all of his/her remaining interest in the property to the same charity before the earlier of: (1) 10 years from the initial fractional contribution and (2) the donor's death.
 - Exceptions apply where initial donee is not in existence
 - Additional tax of 10% of the recaptured amount plus interest

Partial Interests in Donated Property (cont.)

- Recapture also applies if the charitable donee fails to take substantial physical possession of the property or fails to use the property for its exempt purpose during the 10 year or donor death period
 - There is no “reasonable time” period for possession after a triggering event
 - There is also no requirement that the possession by the charity be proportionate to the charity’s fractional interest

Partial Interests in Donated Property (cont.)

- Contributions made before enactment of the law are not considered to be initial fractional donations for these purposes; the first fractional gift after the date of enactment is considered the initial fractional donation

Partial Interests in Donated Property (cont.)

- Prior law allowed valuation based on fractional value of item at time of gift, and if value increased, increased value was used for subsequent gift
- Value of deduction for initial gift of fraction interests is based on fair market value of the property at the time of the contribution

Partial Interests in Donated Property (cont.)

- Valuation of subsequent gifts of that property, whether or not fractional interests, is the lesser of: (1) value used for purposes of the initial fraction contribution, or (2) the fair market value of the item at the time of the subsequent contribution
- Fractionalization discounts apparently will not apply

Partial Interests in Donated Property (cont.)

- Effect of these rules is the worst result possible for donors:
 - Donor must part with possession soon after the gift
 - Donor forced to donate the remaining interests to avoid recapture
 - Valuation of forced donation is limited to value of the property at initial donation, even if it has increased in value
 - Excess value at forced donation is gift/estate taxable - it will not qualify for the charitable deduction

Appraisal Reforms for Charitable Deductions



- Prior law imposed penalties if substantial misstatement was 200% or more of the audited value; PPA lowers the threshold to 150%
- Prior threshold for gross misstatement penalties was 400%; PPA lowers that to 200%
- Gross misstatement penalties no longer excused by reasonable cause arguments

Appraisal Reforms for Charitable Deductions (cont.)



- Also changed thresholds for gift and estate tax purposes
 - Substantial understatement raised from 50% to 65% or less of audited value
 - Gross understatement raised from 25% to 40% or less

Appraisal Reforms for Charitable Deductions (cont.)



- Imposes additional civil penalties for appraisers and redefines qualified appraiser and qualified appraisals
 - This may make it harder, or at least more expensive, for donors to obtain appraisals for tax purposes
 - “Appraiser” may also include anyone who estimates values

New Rules for Split Interest Trusts

- Effective for returns for taxable years beginning after 12/31/2006
- Increased penalties for failing to file returns, failing to include or provide correct information
- Greater penalties for trusts with income over \$250,000 and personal liabilities for penalties to individuals failing to file or provide information
- Eliminates exception to filing requirement for trusts required to distribute all income to beneficiaries

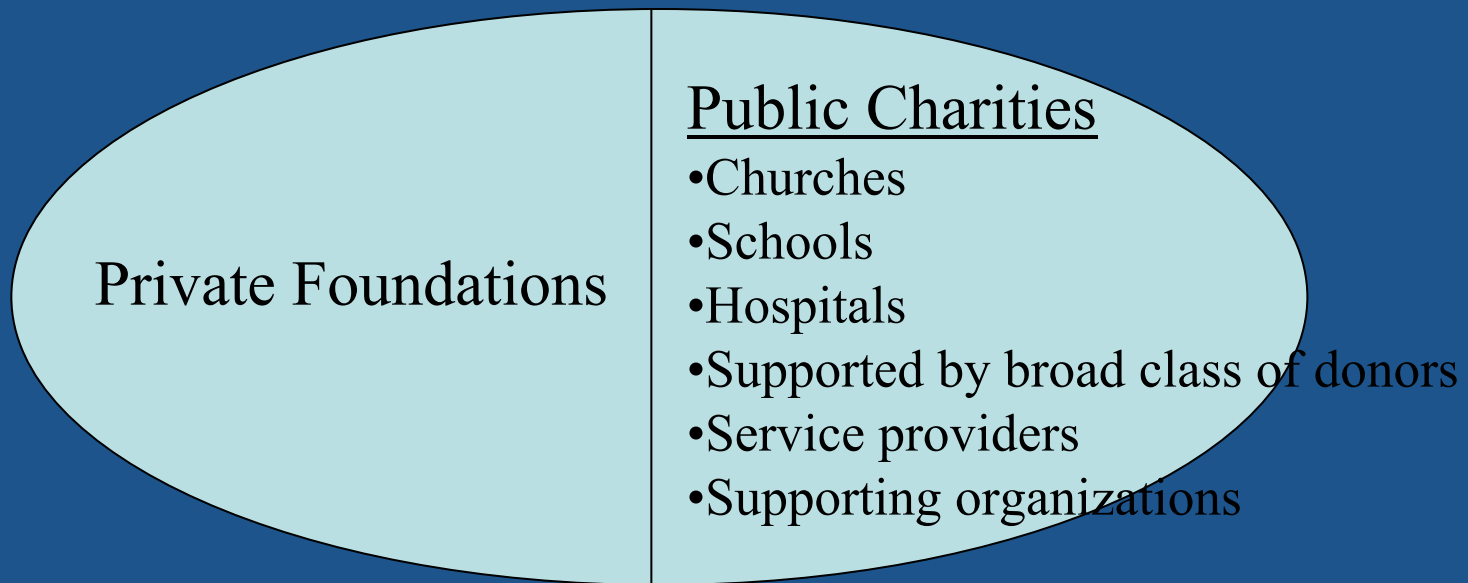
Charitable Organization Reforms

- Aimed at perceived abuses
 - Insider transactions
 - Donor-advised funds
 - Supporting organizations
- Remedy attempts to avoid private foundation rules and oversight

Insider Transactions

- Doubled penalties for a variety of improper transactions with insiders
 - Excess benefit transactions (public charities)
 - Self-dealing (private foundations)
- Added new prohibited self-dealing rules for Donor Advised Funds and Supporting Organizations

Donor Advised Funds and Supporting Organizations



Donor Advised Funds

- Fund or account –
 - Separately identified by reference to contributions of donor or donors
 - Owned and controlled by sponsoring organization
 - Donor retains advisory privileges over distributions or investments by reason of status as donor

Donor Advised Funds (cont.)

- Limits on investments in closely held businesses
- Penalties for distributions to individuals
 - Exceptions for scholarships and disaster relief
- Prohibitions on payments to donors and designated advisors
- Requires reasonable compensation of investment advisors
- Not eligible for gifts from private foundations

Supporting Organizations

- Organization that is not a private foundation because of close relationship with another publicly supported charity
 - Governance control,
 - Overlapping officers, or
 - Substantially all distributions for benefit of beneficiary organization

Supporting Orgs (cont)

- Limits on investments in closely held businesses
- Prohibitions on payments to substantial contributors
- Type III SOs not eligible for gifts from private foundations
- Increased accountability to beneficiary orgs

Practical Considerations

- Be prepared to answer questions about public charity status
 - IRS determination letter states category
- Evaluate carefully situations where donors can provide “advice” regarding use of donations
 - If maintain separate fund, donor has ongoing right to give advice, may be donor advised fund

Practical Considerations

- If Museum has foundation which is a supporting organization
 - Evaluate which type, consider adjusting if needed
 - Have legal opinion or officer certificate as to which “type”
 - Ensure vendors to Museum not substantial contributors to Foundation

Speakers

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