

Date: Feb. 3, 2006

ABA Tax Section Comments on Charitable Giving Provisions in S. 2020

The American Bar Association Section of Taxation in a February 3 letter to the leaders of the taxwriting committees commented on the charitable giving incentives in S. 2020, the Tax Relief Act of 2005, passed by the Senate on November 18, 2005, specifically the charitable contribution deduction for nonitemizers.

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February 3, 2006

The Honorable Charles E. Grassley
Chairman
Senate Committee on Finance
219 Dirksen Senate Office Bldg.
Washington, DC 20510

The Honorable Max S. Baucus
Ranking Member
Senate Committee on Finance
219 Dirksen Senate Office Bldg.
Washington, DC 20510

The Honorable William M. Thomas
Chairman
House Committee on Ways and Means
1102 Longworth House Office Bldg.
Washington, DC 20515

The Honorable Charles B. Rangel
Ranking Member
House Committee on Ways and Means
1106 Longworth House Office Bldg.
Washington, DC 20515

Re: S.2020

Dear Gentlemen:

Enclosed are comments on the proposals included in S.2020 concerning charitable organizations. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Dennis B. Drapkin
Chair, Section of Taxation

Enclosure

cc: Hon. John Snow, Secretary of the Treasury
Eric Solomon, Acting Assistant Secretary of the Treasury (Tax Policy)
Thomas Barthold, Acting Chief of Staff, Joint Committee on Taxation

Kolan Davis, Republican Staff Director and Chief Counsel, Senate Finance Committee
Russell Sullivan, Democratic Staff Director, Senate Finance Committee
Robert Winters, Republican Chief Tax Counsel, House Ways and Means Committee
John Buckley, Democratic Chief Tax Counsel, House Ways and Means Committee

ABA SECTION OF TAXATION COMMENTS ON S. 2020

These comments ("Comments") on S. 2020 are submitted on behalf of the American Bar Association Section of Taxation. The views expressed herein have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by, Lance W. Behnke, Wendell R. Bird, Victoria B. Bjorklund, Eve Borenstein, Michael A. Clark, Jennifer Franklin, Frederick J. Gerhart, Laura Kalick, Lisa Johnsen, Douglas M. Mancino, David A. Shevlin, T.J. Sullivan, Robert A. Wexler and LaVerne Woods. The Comments were reviewed by Richard Gallagher, Council Director of the Exempt Organizations Committee.

Although the individuals who participated in preparing these Comments have clients who would be affected by the federal tax principles addressed by these Comments or have advised clients on the application of such principles, no such participant (or the firm or organization to which such participant belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: Friday, February 3, 2006

EXECUTIVE SUMMARY

The Senate Finance Committee staff on June 21, 2004, issued a Discussion Draft (the "Discussion Draft") reflecting proposals for reforms and best practices in the area of tax-exempt organizations. The Section of Taxation (the "Section") provided comments on the Discussion Draft on July 19, 2004 (the "Prior Comments"). In addition, the Section participated in the Finance Committee's invitational roundtable on the Discussion Draft on July 22, 2004.

A Description of the Chairman's Modification to the Provisions of the "Tax Relief Act of 2005," prepared by the staff of the Joint Committee on Taxation, was released on November 14, 2005. The Chairman's Modifications included wide-ranging provisions concerning exempt organizations and charitable giving, which differ substantially from those previously released in the Discussion Draft. On November 15, 2005, S. 2020, the Tax Relief Act of 2005, was reported out of the Senate Finance Committee, with the Chairman's Modifications. The bill passed the Senate on November 18, 2005. The Comments address the exempt organizations and charitable giving provisions of S. 2020. The House version of the bill does not include those provisions.

S. 2020 includes a variety of charitable giving incentives, including a charitable contribution deduction for non-itemizers. We make technical suggestions on the non-itemizer deduction, but do not take a position on the overall provision.

Under current tax law, deductible payments of rents, royalties and interest made to tax-exempt organizations by certain affiliates are taxable to the recipient, even though such payments generally would not be taxable if received from an unrelated party. The Section supports a provision in S. 2020 that

would make such payments taxable to the exempt recipient only to the extent that the payments exceed fair market value.

S. 2020 requires large charities to obtain special certification from independent accountants or legal counsel of their tax returns on which they report taxable income (IRS Form 990-T), and makes those tax returns subject to public disclosure. The Comments question whether the certification would add materially to compliance, as well as the fairness of the public disclosure provision, given that taxable entities are not required to disclose their returns reporting taxable income.

We make technical suggestions on the implementation of a provision designed to encourage contributions of real property by qualified farmers and ranchers. The Section supports a provision that would allow volunteers who perform services for charities to exclude any reimbursements for mileage expenses from their gross income so that they are not taxed on such reimbursements.

The bill includes numerous provisions designated as reforms to the laws regarding charitable organizations. One such provision imposes a penalty on exempt organizations that are parties to certain transactions that are designated as tax shelters. The Section applauds the bill's efforts to prevent and penalize participation by exempt organizations in abusive tax shelters. We note, however, that the provision treats exempt organizations more harshly than taxable organizations and individuals, who are required only to disclose participation in tax shelter transactions on their tax returns, and who may challenge any Internal Revenue Service assertion that the transaction is objectionable. Further, we note that the definition of a tax shelter transaction under the bill may include many common and legitimate transactions that exempt organizations engage in, and is therefore overbroad.

S. 2020 would impose a penalty tax on tax-exempt organizations in connection with the acquisition of certain types of insurance contracts. The Comments suggest that while there may be some questionable or abusive practices in this area, they would be better addressed under state insurance laws than through the federal tax law.

The bill would increase a variety of excise taxes that currently apply to certain prohibited transactions engaged in by charitable organizations, social welfare organizations, and certain insiders with respect to those organizations. The Comments focus on the need for appropriate abatement provisions and the desirability of providing certain charitable organizations the opportunity to establish a presumption that a transaction is appropriate by following specified procedures in approving the transaction.

S. 2020 includes several provisions that would require additional documentation and recordkeeping to substantiate charitable contributions, as well as new limitations on charitable contributions of easements on buildings in registered historic districts, contributions of clothing and household items, and contributions of fractional interests in tangible personal property, such as artwork. The Comments express support for well-targeted rules to ensure the integrity of the tax law concerning charitable contribution deductions. They question, however, the fairness and practicality of many of the additional requirements, such as the need for a canceled check or receipt from a charity in order for a donor to deduct small donations, including cash contributions made to religious organizations that "pass the plate."

The bill would expand the categories of investment income on which a private foundation is subject to tax to include gains on disposition of assets used in the foundation's charitable purposes. The Comments note that the provision would effectively diminish a private foundation's assets available for furthering its mission.

Under the bill, small tax-exempt organizations that have annual revenues below the current tax return filing threshold set by the Internal Revenue Service would be required to file an annual notice with the Internal Revenue Service. Failure to file this notice for three consecutive years would result in revocation of tax exemption. We suggest that this provision is unduly harsh on the smallest charities that have the least access to knowledgeable legal and accounting advice, and recommend imposing some more modest penalty for failure to provide the notice.

We applaud a provision that would allow the Internal Revenue Service to share information related to exempt organizations with state officials as a desirable measure to enhance coordination of oversight and enforcement by federal and state regulators.

The Comments raise concerns regarding a number of the provisions affecting donor-advised funds, including overly-broad prohibitions against certain types of grants, lack of coordination among new excise taxes, and overly-broad application of certain excise taxes.

In the area of supporting organizations, we express similar concerns that the new restrictions are overly broad. There are three types of supporting organizations. The majority of apparent abuses have been in the area of so-called Type III organizations. S. 2020 would impose significant restrictions not only on Type III organizations, but also on Type I and Type II entities. Our comments suggest that these restrictions unnecessarily inhibit charitable activities, because Type I and Type II supporting organizations, as well as some categories of Type III organizations, pose little potential for abuse. The Comments further criticize a provision that would preclude supporting organizations from supporting foreign charities, which could substantially impede the increasingly important area of international philanthropy, and a provision that would prohibit foundations from making grants to supporting organizations. Other areas of concern include overly-broad excise taxes on transactions with supporting organizations. Finally, we provide specific recommendations to improve reporting rules that apply to supporting organizations.

**ABA SECTION OF TAXATION
COMMENTS ON S. 2020
BACKGROUND AND OVERVIEW**

We commend and support Congressional efforts to promote charitable giving and to address potential tax abuses involving charitable organizations. We believe that some provisions of S. 2020, however, have the potential to affect both charities and donors adversely.

Our most serious concerns relate to the bill's provisions regarding donor-advised funds and supporting organizations. Some of S. 2020's provisions would substantially change the law in those areas. The Discussion Draft included proposals concerning donor-advised funds and supporting organizations, and the Section's Prior Comments addressed those proposals in detail. In addition, in September 2004, the Senate Finance Committee invited Independent Sector to convene a Panel on the Nonprofit Sector to make recommendations to Congress on legal reforms to strengthen effective practices by charities. The Panel released two reports and a draft supplemental report setting out its recommendations, including proposals concerning donor-advised funds and supporting organizations.

Notwithstanding this lengthy deliberative process, many of the provisions in S. 2020 concerning donor-advised funds and supporting organizations had not previously been offered and, therefore, were not subject to public review prior to inclusion in S. 2020. While we support appropriate measures to curb abuses, the provisions in these areas contained in S. 2020 are far too broad. We suggest below a number of ways in which they can be narrowed to address expressed concerns without causing unnecessary harm to our nation's vital charitable sector.

**TITLE III -- PROVISIONS RELATING TO CHARITABLE DONATIONS
SUBTITLE A -- CHARITABLE GIVING INCENTIVES**

Section 301: Charitable deduction for non-itemizers

Under current law, only taxpayers who itemize deductions may deduct charitable contributions. Section 301 of S. 2020 would add a new Code section 170(o), which would modify the current rule to allow a charitable deduction for cash contributions made by individuals who do not itemize. The provision is effective beginning in 2006 and through the end of 2007. The purpose of this change is to encourage charitable contributions by non-itemizers. The bill also imposes a floor on charitable contributions for both itemizers and non-itemizers, which restricts the deduction to an aggregate amount per year in excess of \$210 (or \$420 in the case of a joint return).

Limiting the non-itemizer deduction to cash contributions is a reasonable approach to avoiding abuse. Few non-itemizers are likely to donate appreciated property or other interests invoking the special rules for itemizers, with the possible exception of clothing and other household goods (which S. 2020 separately limits in section 317).

The reference to non-itemizers deducting "the amount allowable under subsection (a)" of section 170 fails to impose the percentage limits on non-itemizers under section 170(b), the restriction on partial-interest gifts under section 170(f), the restriction on donations connected with athletic ticket rights under section 170(l), etc. (The express wording of S. 2020 shows an intent not to allow carryovers for non-itemizers under section 170(d).) This could open a new type of abuse, where individuals wishing to take large cash charitable deductions (without carryforward) would forego itemized deductions in order to avoid these restrictions. We recommend, as the simplest way to fix this problem, to add after "the amount allowable under subsection (a)" the words "and other subsections of section 170 relevant to cash contributions."

We note that while the provision allowing a deduction for non-itemizers would expire at the end of 2007, the \$210 floor (\$240 for joint returns) for itemized deductions (which presumably was imposed to offset the revenue loss attributable to the non-itemizer deduction) would not expire. We believe that the floor for itemizers should expire at the same time that the deduction for non-itemizers expires.

Section 306: Modify tax treatment of certain payments to controlling exempt organizations and public disclosure of information relating to unrelated business income

Modify tax treatment of certain payments

Sections 512(b)(1), (2), and (3) of the Code modify the normal unrelated business income tax ("UBIT") rules to provide that income from certain passive sources, such as dividends, interest, royalties, and certain rental payments, is not unrelated business income. Section 512(b)(13) provides an exception, however, under which interest, annuities, royalties and rents that are deducted by a controlled entity and paid to a controlling tax-exempt entity, are generally unrelated business income to the controlling exempt entity.

Section 306(a) of S. 2020 would amend Code section 512(b)(13) to provide that interest, annuities, royalties and rents that an exempt organization receives from a controlled entity are unrelated business income only to the extent that the payments exceed fair market value.

We support the bill's amendment to Section 512(b)(13). The amendment addresses concerns that many tax-exempt organizations have raised for a number of years.

We further agree that a tax equal to 20% of the excess over fair market value is appropriate, but we find the language discussing amended returns and supplements to be confusing. The provision may also create a disincentive for exempt organizations to file amended returns to correct mistakes in the future. We suggest that the language state simply: ". . . shall be increased by an amount equal to 20% of the amount of the payment that exceeds fair market value."

Public disclosure of Form 990-T

Section 306(b) of S. 2020 would require Form 990-T, on which an exempt organization reports its unrelated business income, to be made public with appropriate redactions, e.g. for trade secrets. The Form 990-T is not subject to public disclosure under present law.

It is not clear to us what purpose the proposed disclosure is intended to serve or what abuses it is intended to remedy. The Form 990, which is subject to public disclosure, contains information about the organization's unrelated business income (Part VII-Analysis of Income Producing Activities) and indicates whether the organization is filing a Form 990-T. We question whether public disclosure of the additional information contained on Form 990-T would further the public's understanding of the organization's activities.

We note that the Congressional policy behind the UBIT was to permit exempt organizations to engage in unrelated businesses but to tax them at rates comparable to taxable enterprises so that they did not

have an unfair advantage. See H.R. Rep. No. 2319, 81st Cong., 2d Sess. 38 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 28-29 (1950). Consistent with this notion of parity of treatment between exempt organizations and for-profit businesses, we believe that exempt organizations should not be treated more harshly than for-profits. Since the tax returns of for-profit businesses are not publicly available, the UBIT returns should not be publicly available either. To require otherwise would, we believe, undercut the "level playing field" goal of Congress in enacting the UBIT regime for exempt organizations. There would be an element of unfairness if exempt organization were required both to pay the UBIT and to lay their books open to taxable competitors.

Certification of UBIT activities

Section 306(c) of S. 2020 would require that large charitable organizations (gross revenue or assets in excess of \$10 million) include with their Form 990 and Form 990-T (if any) a certification by an independent auditor or counsel that the organization's filings accurately reflect the organization's UBIT liability. Failure to satisfy the certification requirement would result in a penalty of 0.5% of the organization's total gross revenues for the taxable year, excluding revenues from contributions and grants.

The provision would require charitable organizations to incur significant additional costs with little justification in terms of enhancing accuracy and accountability. Organizations are already required to abide by the UBIT rules, and large organizations often hire professionals to assist in fulfilling this requirement. We do not believe that requiring certification by "independent" auditors and counsel would add materially to compliance. It might even be difficult to find a qualified auditor or counsel willing to provide such a certificate. We are not aware of other provisions under the tax law that require that an independent party vouch for the accuracy of an organization's or individual's tax return, and to impose this burden on charitable organizations in particular seems unjustified.

Section 307: Encouragement of contributions of capital gain real property made for conservation purposes

Section 307 of S. 2020 would amend section 170(b)(2) to allow a deduction equal to 100% of taxable income (instead of 10% of taxable income) for qualified conservation contributions made by corporations that are qualified farmers or ranchers and whose stock is not readily tradable on an established securities market. It also allows a carryforward for qualified conservation contributions for up to 15 years.

One potential problem is that the Internal Revenue Service, or taxpayers, could read the new percentage limit, which is solely for qualified conservation contributions by corporations that are qualified farmers or ranchers, as meaning that there is no deduction for such contributions by other corporations. We believe that would be incorrect, because section 170(h) otherwise treats qualified conservation contributions as subject to normal percentage limits and carryforward rules. However, uncertainty could discourage conservation contributions, which Congress states it is trying to encourage, and could cause unnecessary controversy. We recommend adding, at the end of the new section 170(b)(2)(B), that "Any qualified conservation contribution made by a corporation which does not meet the requirements of this section 170(b)(2)(B) remains deductible to the extent it was deductible under section 170(b)(2) before this paragraph (B) was added." That would mean an aggregate limit of 10% of taxable income and a five-year carryforward (as restricted in section 170(d)(2)).

We note that section 307 of S. 2020 does not appear to address how the new rules are intended to apply with respect to qualified conservation contributions made by S corporations.

Section 309: Mileage reimbursement to charitable volunteers excluded from gross income

We support this provision as a desirable measure to ensure that volunteers are not taxed on reasonable reimbursements from charities for their mileage expenses.

SUBTITLE B -- REFORMING CHARITABLE ORGANIZATIONS PART I: GENERAL REFORMS

Section 311: Tax involvement by exempt organizations in tax shelter transactions

Section 311(a) of S. 2020 would add new section 4965 to the Code to impose an excise tax on an exempt organization that "is a party to" a "prohibited tax shelter transaction" where the organization knows or has reason to know that the transaction is a prohibited tax shelter transaction. A prohibited tax shelter transaction is defined by reference to Code sections 6707A(c) and 6011, and regulations promulgated thereunder, as a "listed" transaction and certain other "reportable" transactions (confidential transactions and transactions with contractual protection). New Code section 4965 would also impose an excise tax on an entity manager of an exempt organization if the manager knows or had reason to know that the transaction was a prohibited tax shelter transaction. Section 311(b) of S. 2020 would add new Code section 6011(g), under which other parties to a prohibited tax shelter transaction would be required to disclose to an exempt organization party that the transaction was a prohibited tax shelter transaction.

We applaud the objective of S. 2020 to prevent and penalize participation by exempt organizations in abusive tax shelters. We believe, however, that section 311 as currently drafted is overbroad and could inhibit the participation of exempt organizations in common transactions that are not abusive.

By imposing an excise tax on an exempt organization that is a party to a "prohibited tax shelter transaction" in addition to imposing a penalty on an exempt organization that fails to disclose such transaction, section 311 treats exempt organizations more harshly than taxable organizations and individuals who are subject to penalty under section 6707A of the Code. Such taxpayers may avoid section 6707A penalties with respect to reportable and listed transactions by making the required disclosure with a return. In addition, a taxable person who realizes a tax benefit from the transaction has the opportunity to challenge the Internal Revenue Service's position that the transaction is objectionable and, if successful, avoids any additional tax or penalty.

The excise tax proposed by section 311, on the other hand, is a "no-fault" penalty, imposed irrespective of whether the listed or reportable transaction is ultimately determined to be abusive. Such a tax might be warranted if the "listed" and "reportable" transaction definitions were more precisely targeted to encompass only transactions that are clearly abusive. Those definitions are designed to encourage disclosure of a wide range of transactions, however, and are therefore likely to remain broad and imprecise, and to include within their scope legitimate transactions that should not give rise to penalties.

For example, under section 6707A(c)(2), a "listed transaction" includes a transaction "substantially similar" to an existing listed transaction. Because various legitimate financial products, such as equity swaps, may be "substantially similar" to contingent notional principal contracts designated as listed transactions by IRS Notice 2002-35, many taxpayers have made protective filings with the Internal Revenue Service to avoid possible penalties for failing to disclose participation in common investment management transactions. Under proposed section 311, exempt organizations would have to refrain from entering into such legitimate transactions to avoid the potential imposition of the no-fault penalty.

With respect to "reportable transactions" that are confidential transactions or transactions with contractual protection, in contrast to listed transactions, the IRS has made no determination that any such transaction is an abusive tax shelter. Indeed, the proposed legislation misconstrues the role of the reporting requirements related to potential tax shelters. These requirements are intended to provide the IRS with information on a timely basis so that the IRS may subsequently determine which transactions to examine, and from those examined, which transactions to challenge. Moreover, due to the penalties imposed on those who fail to comply with these reporting requirements, taxpayers tend to err on the side of over-reporting. As a result, a large portion of the transactions reported to the IRS may be in compliance with applicable tax laws. We understand, for example, that certain low-income housing transactions (which often involve exempt organization participants) are reported because they could be construed as having contractual protection, notwithstanding that the underlying tax benefits are clearly sanctioned by Congress. Customary agreements by investment managers not to expose exempt organizations to unrelated business income tax could also be construed to involve "contractual protection," and therefore be reportable transactions subject to penalty. There is an insufficient correlation between the enumerated transactions that are reportable or reported, on the one hand, and the presence of an actual abusive tax shelter, on the other hand, to justify the imposition of penalties on tax-exempt entity participants.

We thus suggest that the application of section 311 be limited to imposing an excise tax for failure to disclose "prohibited tax shelter transactions," rather than for entering into such transactions.

If any excise tax is imposed on an exempt organization in connection with a listed or reportable transaction, there should be mechanisms put in place that are reasonably designed to alert exempt organizations to the types of transactions that may be encompassed by the definition of "prohibited tax shelter transactions." Most exempt organizations (as well as many professional advisors who practice primarily in the exempt organizations area) are unfamiliar with the concepts of listed and reportable transactions, and would be at a loss as to what resources to consult in order to identify listed and reportable transactions.

We recommend that any excise tax apply only with respect to participation in those listed transactions that have been specifically identified as such and described in plain language in an IRS Notice or other publication that is directed *specifically to exempt organizations*. Appropriate notice would include, for example, listing on the IRS web site pages for Charities and Non-Profits. Appropriate references to the site in forms commonly used by charities, such as IRS forms 1023, 1024, and 990, would also be helpful.

If any excise tax will apply to an exempt organization that is a party to a reportable transaction that is not a listed transaction, we suggest that section 311 of S. 2020 be revised to clarify that an exempt organization will not be deemed to know or have reason to know that a transaction was a "reportable transaction" unless and until the exempt organization receives the disclosure described in new section 6011(g), as added by section 311(b)(2) of S. 2020. This clarification is necessary because a reportable transaction may fall into that category as a result of provisions in documents that are provided only to other parties to the transaction, and not to the exempt organization. Section 6011(g) should also be amended to require disclosure to the exempt organization at the inception of the exempt organization's participation in the transaction. An organization that does not receive the required disclosure should not avoid penalties, however, if the provision causing the transaction to be reportable is contained in a document to which the exempt organization is a party (such as a confidentiality agreement).

We also note the absence of any guidance as to when a tax-exempt entity would be considered to be "a party to" a transaction, as that term is used in new Code section 4965. This determination is critical to evaluating whether the tax-exempt entity may be subject to the proposed tax penalties. The sparse legislative history uses "participate" interchangeably with being a "party," but this does little to elaborate on the nature of tax-exempt entity involvement with a transaction that could expose it to the new penalties. See Joint Committee on Taxation, "Description of the Chairman's Modification to the Provisions of the 'Tax Relief Act of 2005,'" 28-29, Nov. 14, 2005, JCX-77-05.

Finally, we recommend that new Code section 4965(a)(2) be revised to clarify that the excise tax on an entity manager would apply only if the manager knew or had reason to know that the transaction was a prohibited tax shelter transaction, determined under the standards recommended above

Section 312: Excise tax on certain acquisitions of interests in insurance contracts in which certain exempt organizations hold an interest

Section 312 of S. 2020 would add new section 4966 to the Code to impose an excise tax on acquisitions of certain types of insurance contracts by tax-exempt organizations. In recent years, insurance brokers, investment bankers and others have solicited exempt organizations to purchase policies on the lives of individuals with whom they might have little or no relationship as a means of avoiding state insurable interest requirements. The premiums are financed by a third party and after a period of time (usually two years) the exempt organization has the option of retaining the policy and paying the loan or giving the policy to the lender. Under S. 2020, the exempt organization would be subject to an excise tax unless the policy satisfied specific criteria.

While we agree that there may be some questionable or abusive practices in this area, we understand that there are legitimate and appropriate practices that would also be covered under this proposal. Colleges and universities sometimes purchase life insurance policies on the lives of their alumni in connection with fundraising drives such as capital campaigns, often with the alumni donating the premiums for the policies. If the college or university later disposed of the policy to a life settlement

company (which might be desirable, e.g., if the insured individual ceased to donate premium amounts), any gain on such disposition could be subject to the excise tax.

We believe that the issues raised by Section 312 would be more appropriately addressed by state laws defining appropriate insurable interests.

Section 313: Increase in penalty excise taxes on public charities, social welfare organizations, and private foundations

Excise taxes on public charities and social welfare organizations

Section 313(d) of S. 2020 would amend Code section 4958(d)(2) to raise the maximum excise tax on organization managers who participate in an excess benefit transaction, unless such participation is not willful and is due to reasonable cause, from \$10,000 to \$20,000. We support the increase in this limit as an appropriate deterrent to willful violations.

Excise taxes on private foundations

Code sections 4941 - 4945 impose excise taxes on certain prohibited transactions involving private foundations (self-dealing, failure to distribute income, excess business holdings, investments that jeopardize charitable purposes and taxable expenditures). Each section imposes two tiers of taxes with respect to such transactions: an initial first-tier tax, and, if the transaction is not corrected, a more severe second-tier tax. The first-tier excise taxes are automatic and imposed regardless of whether the taxpayer knowingly or intentionally violated the prohibitions of Code sections 4941 - 4945, and regardless of whether a transaction is fair or even beneficial to a foundation. Section 4962 authorizes the Secretary to abate the first-tier taxes, other than the tax on self-dealing under section 4941(a)(1), if the taxable event was due to reasonable cause and not due to willful neglect. This excise tax scheme provides a significant, but not unreasonable, cost to the parties for failing to conform to the private foundation excise tax rules, even if failure is due to lack of knowledge.

Sections 313(a), (b), (c) and (d) of S. 2020 would generally double the first-tier taxes imposed on disqualified persons and foundation managers under Code sections 4941 - 4945. With respect to self-dealing, section 313 of S. 2020 would also add a new provision that would make the first-tier tax equal to 25% in the case of compensation paid to a disqualified person. This special first-tier tax for compensation-related self-dealing would be coupled with a provision authorizing the Secretary to abate up to 15% of the tax under the abatement provisions of Code section 4962. The provision would not offer the opportunity for complete abatement of a first-tier tax for self-dealing.

If the excise taxes for self-dealing transactions are to be increased, section 4962 of the Code should be amended to authorize the Secretary to abate the taxes for self-dealing transactions that are due to reasonable cause and not due to willful neglect. For large private foundations with extensive disqualified person relationships (e.g., where there is a huge number of disqualified persons or where at least one disqualified person is a large unaffiliated multi-national corporation), it is extremely complex if not impossible to track all potential self-dealing transactions.

Further, if the excise tax for compensation-related self-dealing is to be increased to 25% to mirror the tax applicable to excess benefit transactions under section 4958, organizations should be afforded an opportunity to establish a rebuttable presumption of reasonableness by following specified procedures similar to those under section 4958. Private foundations want and need to attract quality professionals as key executives and as board members. To do so, they must be able to pay market compensation and assure board members that they will not suffer personal penalties if they make prudent, well-informed decisions.

With respect to the excise tax on jeopardizing investments, we recommend directing Treasury to update and modify regulations under section 4944 rather than increasing penalties for violating the current regulations, which were drafted over 30 years ago and no longer provide useful guidance as to what constitutes a jeopardizing investment. The examples of types or methods of investment which will be closely scrutinized described in Treasury Regulation section 53.4944-1(a)(2)(i) do not reflect current investment practices and opportunities and do not recognize the current balanced-portfolio practices of

foundations, including so-called alternative investments. Foundations today use sophisticated investment strategies to attempt to manage portfolios in accordance with modern portfolio theory, volatility considerations, and other matters. Rather than increase penalties in an area where a violation of the rules is unclear, the charitable community and the tax system would be better served by having updated and clarified rules.

Section 314: Reform charitable contributions of certain easements on buildings in registered historic districts

Section 314 of S. 2020 would impose special rules for conservation easements, or restrictions for certified historic structures. Under section 314, any facade easement (called in the Code a restriction with respect to the exterior of a building) would be required to apply to the entire exterior of the building, to prohibit any change to the exterior inconsistent with its historical character, and to include a written agreement certifying under penalty of perjury that the donee is a qualified organization for conservation contributions and has the resources and commitment to manage and enforce the restriction. The donor would be required to attach to the relevant tax return the qualified appraisal, photographs of the entire exterior, and a description of all restrictions on development of the building, and a \$500 filing fee if the deduction claimed exceeded the greater of 3% of fair market value of the building or \$10,000.

We support well-targeted rules to ensure the integrity of the tax law concerning charitable contribution deductions. In furtherance of that objective, we recommend several revisions to section 314.

First, the language concerning preserving and photographing "the entire exterior" literally includes the roof surface. Preservation of a roof surface has never been viewed as relevant to historical preservation, however (though preservation of the roofline and shape has). For example, a deteriorating historical building may be suffering harm from a leaky roof made of substandard materials, and may be much better preserved by more enduring materials with preservation of the street appearance. Photographing the roof may become an expensive undertaking if a tall building nearby does not provide a vantage point. We recommend either replacing "the entire exterior" with "the entire exterior visible from accessible vantage points," or directing the Secretary of the Treasury to promulgate regulations to address this issue.

Second, we question whether there is a justification for imposing a user fee. We are not aware of any user fees that are imposed for any other types of gifts, other than the user fee for the *optional* statement of value that a donor may request from the Internal Revenue Service for art appraised at more than \$50,000. Further, we note that the filing fee is placed in section 170(f), while the requirements for what must be attached to a tax return are placed in section 170(h). These requirements are already complex and a trap for the unwary. Placing prerequisites for a deduction in two places in a very long Code provision widens the trap for the unwary, punishing taxpayers or advisors who in good faith seek to comply and do not suspect that a second requirement lurks elsewhere. We recommend, rather than moving either provision, simply adding cross references to both. Thus, new section 170(h)(4)(B)(iii) (referring to the attachment to the taxpayer's return) would add "(in addition to the requirements of section 170(f)(13))," and new section 170(f)(13)(A) would add "(in addition to the requirements of section 170(h)(4)(B)(iii))."

Third, the threshold for the \$500 filing fee is based on the greater of 3% of the "fair market value of the building (determined immediately before such contribution)" or \$10,000. This seems unnecessarily complex. We suggest that a threshold of \$10,000 would be much simpler. If the user fee is maintained, we support the exemption from the user fee for small donations.

Fourth, the subheading in section 314 of S. 2020 for the middle part of the new provision, "(b) Disallowance of Deduction for Structures and Land in Registered Historic Districts," changes current Code section 170(h)(4)(B), which has no reference to disallowing a deduction but instead defines a certified historic structure. The subheading invites misinterpretation of what the middle part is seeking to achieve. It is obvious that the deduction is disallowed if the old and new requirements are not met. We recommend replacing "(b) Disallowance of Deduction for Structures and Land in Registered Historic Districts" with "(b) Additional Requirements for Deduction for Structures and Land in Registered Historic Districts."

Section 315: Charitable contributions of taxidermy property

Section 315 of S. 2020 would amend Code section 170(f) to impose special rules for any contribution of "a mounted work of art which contains any part of a dead animal." A donor who claimed a deduction of more than \$500 would be required to include a photograph of the property and data with respect to the sales price of similar property with the donor's return. A donor who claimed a deduction of more than \$5000 would be required to notify the IRS of the deduction and to include with the donor's return either a statement of value from the IRS or a request for a statement of value from the IRS and a \$500 fee. These requirements would apparently apply to a donation of any mounted work of art that included elements of leather, fur, ivory, bone, teeth, feathers, silk, etc. This could encompass a wide variety of art works, artifacts and specimens that may be contributed to art, design, crafts and natural history museums, as well as other charities.

Under current law, a donor of any property (other than publicly traded securities) who claims a deduction of more than \$500 must complete IRS Form 8283 and submit it with the donor's tax return. Donors who claim a deduction of more than \$5000 must in addition obtain a qualified appraisal of the property and attach an appraisal summary to the return. See IRS Announcement 90-25, 1990-8 I.R.B. 25; Treas. Reg. § 1.170A-13(c). These rules are designed to enable the IRS to identify potential valuation overstatements.

We recognize that there have been recent anecdotal reports of abuses involving valuations of taxidermy property. It is nevertheless not evident that section 315 of S. 2020 would enhance enforcement, or that there is a compelling reason that "a mounted work of art which contains any part of a dead animal" should be subject to special rules that are more onerous than those applicable to contributions of other types of property. We also question whether requiring the IRS to be involved in the valuation process for this type of property is a desirable allocation of the agency's resources.

Section 316: Recapture of tax benefit for charitable contributions of exempt use property not used for an exempt use

Section 316 of S. 2020 would amend Code section 170(e)(1)(B), which deals with contributions of tangible personal property for a use that is related to exempt purposes. The amendments would limit the donor's deduction to tax basis for a contribution of such property if the charity disposed of the property during the tax year of contribution, and would recapture as income the excess deduction over the donor's basis if the charity disposed of such property during the three-year period beginning on the date of contribution, unless the charity made a specific certification. The recapture would be in the year of disposition, and would not require amendments to a prior year's return. Section 316 of S. 2020 would also amend Code section 6050L, which requires a donee to notify the donor if it disposes of contributed property other than publicly traded securities within two years, to extend the reporting period on dispositions to three years. (This reporting is made on IRS Form 8282.) Section 316(c) of S. 2020 would add new Code section 6720B to impose a penalty of \$10,000 for knowing identification of applicable property as having a related use if the contributed property were not so intended.

First, we question the practicality of the recapture rule. There might be any number of situations in which recapture would be unfair and inappropriate, e.g., where a school receives a vehicle and trades it for a larger vehicle, where a museum receives a painting and lends it indefinitely to another museum, or where a judgment creditor forecloses on the recipient charity's property.

We further question whether there is any practical justification for extending the current two-year reporting period on dispositions to three years.

We support in principle the provision under which a donor would not be subject to recapture if the charity made a certification that the contributed property was intended to have a related use, and did enjoy a related use, but then the intended use became impossible or infeasible to implement.

The recapture requirement would produce an unfair result, however, if a charity that initially promised a related use did not in fact implement a related use, or refused to sign a certification that would be accurate. A donor, by contributing the donor's entire interest in the property, loses the ability to ensure

that the charity does as it promises, and an overly cautious charity could well refuse to sign a later certification. The penalty associated with a charity's knowing execution of a false certificate would, we believe, result in many charities being unwilling to sign the required certificate under any circumstances, even though it would be fully accurate. In our experience, charities are sometimes reluctant to sign even the current IRS Form 8283 donee acknowledgement, merely because the prospect of signing a tax document is intimidating, and the staff members of charities often have no background in such matters.

If the recapture provision is retained, we recommend that an alternative be added to the end of the certification exception in new Code section 170(e)(7)(B)(ii), as follows: "or unless the taxpayer carries the burden of proof of showing that the taxpayer sought and the donee declined to give such certification and that the facts support each requirement of the certification."

Section 317: Limitation of deduction for charitable contributions of clothing and household items

In general, a donor may deduct the lesser of tax basis or fair market value for contributions of clothing and household items that the recipient charity will not use in an exempt use. See Code section 170(e)(1). Under Code section 170(f)(11)(C), a donor must obtain a qualified appraisal to claim a deduction of more than \$5,000 for a contribution of property.

Section 317(a) of S. 2020 would add a new Code section 170(f)(15), which would require the Secretary of the Treasury to publish annually an itemized list of clothing and other household items and to assign a value to each item representing the fair market value of such items in good used condition. Deductions for contributions of clothing or household items for which the donor has obtained a qualified appraisal would be limited to the amount indicated on the list for items in good used condition or better, to 20% of the listed amount for items not in good used condition or better, and to \$0 for nonfunctional items. An exception would apply for contributed items for which a deduction of more than \$500 is claimed if the donee sells the item before the earlier of the donor's tax return due date (as extended) or actual filing date, if the sale price is reported to the donor and if the deduction claimed does not exceed the sales price. Food, paintings, antiques, objects of art, jewelry and gems, and collections are not "household items." The provision would not apply to contributions by C corporations.

First, we question whether requiring the Internal Revenue Service to produce an annual list of the values of household items is a desirable allocation of that agency's limited resources. There does not seem to be enough potential for abuse in this area to warrant the additional burdens on the IRS, charities and donors.

Second, this provision would discourage donations of items worth more than the amount on the IRS list, even if the average prices on the list were accurate, such as expensive coats and suits, which can generate more revenue for once-a-year auctions, thrift shops and other wholly charitable activities than average items. For example, the deduction for a recently-purchased outfit with a fair market value of \$500 worn only a few times and remaining in superior condition would be limited to the IRS list amount for average items, which could be \$100, unless the charity happened to sell it before the end of the year of donation and report it to the donor.

Section 317(b) of S. 2020 would amend the substantiation provisions of Code section 170(f)(8)(B) to require that the donee's acknowledgment of a contribution of \$250 or more of clothing or household items include a list of the number of items, the condition of each, a description of the type of item, and a copy of the IRS-produced list assigning maximum values. This requirement seems likely to impose a tremendous burden on organizations that operate thrift shops as a substantial activity.

Finally, if the new substantiation requirements are retained, we recommend adding cross-references to the changes. Specifically, we recommend adding to the beginning of new section 170(f)(15) "In addition to the acknowledgment required under section 170(f)(8)," and to the beginning of new section 170(f)(8)(B)(iv) "in addition to the requirements of section 170(f)(15),".

Section 318: Modification of recordkeeping requirements for certain charitable contributions.

Section 318 of S. 2020 would amend Code section 170(f)(8) to require donors to obtain written acknowledgments as described in that section for all contributions of \$100 or more, rather than \$250 or more, as under current law.

Section 318 would also add new section 170(f)(16), which provides that no charitable deduction is allowed "for any contribution of a cash, check, or other monetary gift" unless the donor maintains a cancelled check, or a receipt or letter from the donee giving its name, the date, and the amount."

With respect to the amendment to section 170(f)(8), we do not see a compelling reason to increase the burden on donors and charities by lowering the threshold for written acknowledgments meeting the requirements of that section from \$250 to \$100. In "quid pro quo" situations where the donor makes a gift of more than \$75 and receives something of value in return, the recipient charity is already obligated to provide a written acknowledgment under Code section 6115 setting out the amount contributed, the value of any return benefit, and stating that the amount deductible is limited to the excess of the amount contributed over the value received.

With respect to new Code section 170(f)(16), we suggest that the provision is ill-considered and will adversely affect both charities and donors, hurting small charities and donors the most.

First, the "maintains a cancelled check" alternative is in conflict with changing banking policies. Banking regulations are in the process of eliminating cancelled checks over the next two years, regardless of whether the taxpayer wishes to receive cancelled checks. In the present electronic funds environment, a significant number of taxpayers do not receive cancelled checks already. We understand that banks will make electronic copies (which used to be microfilm copies) of cancelled checks available, as they do now for a substantial fee, and that some but not all banks will provide the option of electronic copies of all cancelled checks, but only for either a high account fee or a high minimum balance. Thus, a requirement to maintain cancelled checks, at the very time they are becoming extinct, does not match reality. We recommend that the "cancelled check" alternative be replaced by: "a cancelled check or ability in the event of audit to obtain a copy of a cancelled check or other documentary evidence from bank records indicating the name of the donee organization, the date of the contribution, and the amount of the contribution."

Second, the option of a "receipt or letter from the donee giving its name, the date, and the amount" is in conflict with reality, at least until the total of such gifts exceeds a reasonable threshold, for a number of reasons.

A large portion of charities "pass the hat" at periodic events. New section 170(f)(16) would make all such contributions nondeductible, because the logistics of passing the hat at a stadium, a large conference, a play, or a similar event do not allow for donor envelopes and reply receipts. It would be an unfair burden on charities to have to issue receipts for \$1 gifts. It would be a deterrent to \$10 or \$20 gifts to require pens to be passed out, people to give their address (which they may not wish to give), and the hat passers and the program to wait. The need to prepare and send receipts would impose great costs on charities, and needs for additional personnel.

Roughly half of charitable dollars are given to churches and other religious organizations, which typically "pass the plate." The same deterrence to contributions, and addition to administrative burdens, would apply to them. Many schools and other charities raise funds by small donations to pay \$1 a mile for walking or running, or to give \$5 or \$10 for particular outreaches. Neither school children nor teachers and administration are equipped to generate large numbers of receipts. The Salvation Army raises small contributions in kettles at the doors of malls across the country to help the poor and others, while Masonic and social service organizations walk between cars at intersections with cans to raise money for hospitals and other charities. It seems to us unnecessary and unfair to legislate that all these forms of contributions should become nondeductible.

We suggest that this provision either be eliminated, or apply only to contributions above an aggregate threshold, such as "for amounts totaling above \$210 per year (\$420 in the case of a joint return)," which would mirror the new deduction provision for non-itemizers and the floor on the deduction for itemizers at section 301 of S. 2020.

Section 319: Contributions of fractional interests in tangible personal property

Under current law, a donor may claim a charitable contribution deduction under Code section 170 for a gift of an undivided portion of the donor's entire interest in property. See Treasury Regulation § 1.170A-7(a)(2)(ii). The donor may in future years claim additional deductions for additional contributions of undivided fractional interests in the same property. In situations where the donor is entitled to claim a deduction equal to the fair market value of the interest, the value is determined at the time of the contribution.

Section 319 of S. 2020 would add new Code section 170(p) to limit deductions for gifts of fractional interests in tangible personal property after an initial contribution of a fractional interest in such property to the lesser of the valuation at the time of the initial contribution or the valuation at the time of the later contribution.

This would discourage early contributions of fractional interests in appreciating assets (such as works of art, which have appreciated dramatically over the past 50 years), and would encourage delay in making contributions (which charities know would mean many would never be made).

New Code section 170(p) would also require the Secretary of the Treasury to provide for recapture of a charitable deduction if the property "is not in the physical possession of the donee" for its ownership fraction of the year. This would be desirable if the donee wanted to exhibit or otherwise hold the work of art or other tangible personal property. But it would impose high costs, e.g., for storage, transport, and insurance, if the donee were not yet ready to exhibit or otherwise use the work of art or other property. For example, a museum may plan to build a new wing to exhibit newly donated art, but may not want to pay high storage and transport costs in the meantime, and would not welcome a requirement that paintings be "physically possessed" by the museum for a fraction of the year. Annual shuttling of a painting or a statue between the fractional donor and the museum may not only be very expensive, but also very risky for damage or theft. We recommend that the phrase "in the physical possession of the donee" be modified by adding "(unless the property is not physically possessed that year at the donee's request)."

Section 320: Provisions relating to substantial and gross overstatements of valuations of charitable deduction property

Section 320(a) of S. 2020 would add new Code section 6662(i) to change the definition of substantial valuation misstatements, for charitable contributions only, from 200% to 150% of the final value, and would change the definition of gross valuation misstatements, for charitable contributions only, from 400% to 200% of the final value. This would affect penalties on taxpayers. Section 320(b) of S. 2020 would add new Code section 6695A to impose penalties on appraisers whose appraisal violated these modified thresholds at the greater of 10% of the amount of the understatement, or \$1,000, or 125% of the gross income received for preparing the appraisal.

We question whether this difference in treatment between charitable gift valuations and other valuations is justified. There is no obvious reason why the penalties for charitable valuations should differ from those for other valuations. The assets being valued for charitable gifts are generally the same types as the assets being valued for gift tax, or estate tax, or business exchanges, and logically the same rules should govern.

Section 322: Expansion of the base of tax on private foundation net investment income

Section 322 of S. 2020 would expand the definition of gross investment income to include certain items of income not presently enumerated in the Code, but listed in the Treasury Regulations under section 4940, including income from notional principal contracts, annuities, and other substantially similar income from ordinary and routine investments. While it may be appropriate to treat all investment income similarly, we suggest that this change should be coupled with a simplification of section 4940 by fixing the tax rate at 1% and by making such changes as may be necessary to ensure that the revenues collected from such tax can be used for their intended purpose -- to serve as an audit or user fee to pay for the cost of regulating private foundations.

Section 322 of S. 2020 would also expand the capital gains subject to the tax to include capital gains from the sale or disposition of assets used to further an exempt purpose. This provision is inconsistent with the original purpose of section 4940, which was to serve as an audit or user fee that would fund the administration needed to supervise private foundation compliance under the newly-enacted Chapter 42 excise tax provisions. See H.R. Rep. No. 413, pt. 1, 91st Cong. 1st Sess. 19 (1969); S. Rep. No. 552, 91st Cong., 1st Sess. 27 (1969); Conf. Rep., H.R. Rep. No. 782, 91st Cong., 1st Sess. 278 (1969). The excise tax currently generates revenues far in excess of the IRS's costs of administering the private foundations. See STAFF OF THE JOINT COMMITTEE ON TAXATION, STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, Vol. II 459 (April 2001).

Expanding the tax to apply to gains from the disposition of assets used in a private foundation's charitable purpose would also reduce the amount of sale proceeds that can be redeployed for the foundation's charitable purposes. For example, assume that a private foundation's charitable purpose is to make scholarships for students to attend University. As part of its scholarship program, a private foundation owns and operates a "common room" building adjacent to University X which it uses in furtherance of its charitable purpose. The private foundation decides to sell the existing building and construct a larger building that meets its expanded needs. Sale of the old building generated \$100x, and the cost of the new building is \$100x. If the private foundation must pay the section 4940 excise tax on its gain from the sale of the old building, it cannot acquire the new building with the net proceeds, even though the building will be used for same charitable purpose. Even taxable entities can enjoy the deferral provided by section 1031 or 1033, in which the taxpayer can defer tax until a true liquidation event. If gain from disposition of assets used in a foundation's charitable purpose must be subject to the section 4940 tax, there should be a provision that allows for deferral if the entire amount of the gain is reinvested in other assets that will be used for the foundation's charitable purposes.

Section 324: Notification requirement for entities not currently required to file

Section 324 of S. 2020 would amend section 6033 of the Code to require small charitable organizations that receive annual revenues below the Form 990 filing threshold to file an annual notice with the Internal Revenue Service setting forth, among other things, the organization's name, address, EIN and evidence supporting its continued exemption from the Form 990 filing requirements. If a charitable organization failed to file this notice for three consecutive years, the organization's Code section 501(c)(3) status would be considered revoked.

We support in principle an annual filing requirement to establish that a small organization continues to exist and operate. We do not support section 324 of S. 2020 as drafted, however.

First, the penalty of revocation of exemption for a small charitable organization's failure to file an annual notice seems unduly harsh. Such organizations fall below the Form 990 filing threshold because they normally receive \$25,000 or less in annual revenues. These organizations will have limited resources (including limited access to accounting and/or legal assistance) and likely no prior experience with meeting annual IRS filing deadlines. A small charitable organization could easily inadvertently miss one or more annual notice filing deadlines and thereby unknowingly jeopardize its tax-exempt status.

Section 324 of S. 2020 would require that the Secretary of the Treasury timely notify a small charitable organization of the annual notice filing requirement and the penalty for non-compliance. Often such an organization will have changed its address since it submitted its Form 1023 application, however, and its address with the Secretary of the Treasury and Internal Revenue Service may not be current. Small organizations generally do not have an office, and their addresses change as their volunteers move or change. This could result in a small charitable organization having no knowledge of the new annual notice filing requirement from the outset, and lead to inadvertent non-compliance. If this provision were enacted, a major IRS informational campaign would be necessary to make small organizations aware of it.

We recommend that the Secretary of the Treasury be required to notify a small charitable organization of its failure to file each annual notice so that the organization can be given the opportunity to cure the

failure to file. This would be a helpful and necessary remedy for those small charitable organizations that inadvertently fail to file the required annual notice. In addition, although a small charitable organization's exemption may be retroactively reinstated if the organization can show reasonable cause for the failure to file, the provision does not contain any kind of "intermediate sanction" for a small charitable organization and leaves only the option of revocation in cases of non-compliance with the annual notice filing requirement. Some sort of an "intermediate sanction," such as a modest monetary penalty imposed on the organization, along the lines of what is currently imposed on charitable organizations that fail to file a timely Form 990, could also be helpful.

Finally, we suggest that greater specificity is desirable in the legislative language to assist small organizations in complying with the requirement. In particular, rather than requiring that the organization indicate the "continuing basis" for its exemption from the filing requirements under subsection (a)(1) (which, presumably, is that its gross receipts fall below the relevant filing threshold), the organization could be asked to certify that in the year of the exemption from filing, and the two prior years, the total gross receipts received by the organization did not exceed the applicable threshold as calculated under current section 6033(a)(2)(A)(ii) or (a)(2)(B).

Section 325: Disclosure to state officials of proposed actions related to exempt organizations

We support this provision, which would allow the Internal Revenue Service to share information with state officials, as a desirable measure to enhance coordination of oversight and enforcement by federal and state regulators.

PART II: IMPROVED ACCOUNTABILITY OF DONOR-ADVISED FUNDS

Section 331: Excise tax on sponsoring organizations of donor-advised funds for failure to meet distribution requirements

Section 331 of S. 2020 would impose three new excise taxes to penalize certain actions by donor-advised funds, their sponsoring organizations, and their donors and advisors. The first excise tax (new section 4967) would be imposed on the failure to meet minimum distribution requirements imposed both on the sponsoring organization in the aggregate (5% of assets annually) and on each of its donor-advised funds (2.5% of the minimum required balance in every three-year period). The second excise tax (new section 4968) would be imposed on "taxable distributions" from a donor-advised fund, which are distributions to any person unless the recipient is an organization described in section 170(b)(1)(A) (other than another donor-advised fund or certain supporting organizations). The third excise tax (new section 4969) would be imposed if a donor, advisor or related person received more than an incidental benefit as a result of a distribution from a donor-advised fund. Among the concerns raised by sections 4967-4969 are the following:

1. The term "donor-advised fund" is broadly defined to include any fund or account separately identified by reference to contributions of one or more donors where the donor or a person designated by the donor has advisory privileges with respect to its distribution or investment. There are only two exceptions from this broad definition. One is a limited exception for funds providing scholarships and other grants for travel, study or similar purposes if the advisors are appointed by the sponsoring organization and the fund satisfies the rules applicable to similar grants made by private foundations, including the requirement that the grant procedures be approved in advance by the IRS. It is common for donors to retain advisory rights for scholarship programs in a grant agreement, and those arrangements would fall outside the exception. Requiring advance IRS approval of scholarship procedures would be burdensome for the many schools, universities and community foundations that have such programs. The absence of any grandfathering or transitional relief for the thousands of scholarship programs already in existence is also problematic. The second exception to the definition of donor-advised fund authorizes, but does not require, the Treasury to exempt funds (1) that are advised by committees that are not controlled by the donor or (2) that benefit a single identified organization or governmental entity or a single identified charitable purpose. The Treasury should be given broader authority to exclude funds from the definition of donor-advised fund, including a fund created by a charity. Until the Treasury issues final regulations, the definition of donor-advised fund is so broad that it would extend to a sweeping array

of gift arrangements, including virtually any restricted gift allowing the donor some voice in the use or investment of the gift. Without grandfathering or transitional relief for existing arrangements or at least a delay in the effective date until regulations are finalized, the potential application of these penalties to many well-accepted forms of charitable giving could create havoc in the charitable community.

2. S. 2020's broad definition of donor-advised fund would include a fund where the advisory rights apply only to the investment of the fund. There are many legitimate arrangements where charities allow donors a voice in the investment of funds they have contributed. It is not apparent why such arrangements should be subjected to minimum distribution requirements and other excise taxes.

3. Grants from donor-advised funds to organizations not described in section 170(b)(1)(A) would run afoul of two excise taxes. Such grants would not count toward the proposed minimum distribution requirement of section 4967, and they would be subject to the excise tax on taxable distributions of section 4968. This would seriously inhibit, if not eliminate, grants from donor-advised funds to a wide variety of organizations, including grants to organizations such as Rotary Clubs for charitable purposes and to most foreign organizations. Legitimate international grantmaking programs that have implemented procedures to ensure appropriate use of charitable funds would no longer be able to operate if these provisions are enacted.

4. These proposed excise taxes would effectively prohibit donor-advised funds from making grants to Type III supporting organizations. This limitation fails to distinguish among Type III supporting organizations that may present opportunities for abuse and those that do not. The limitation would in particular adversely affect those Type III supporting organizations that are established by public charities (not by donors), such as endowment foundations established for appropriate legal or programmatic reasons by state universities, hospitals and other public charities. Typically, the governing body of such an organization does not include substantial contributors and represents the broad interests of the public or the public charity that has established the organization. An appropriate exception is needed for such organizations and/or grandfathering of existing organizations, perhaps by granting Treasury the authority to exempt by regulation Type III organizations that meet appropriate criteria, comparable to the authority granted to Treasury to deny by regulation a deduction for contributions to donor-advised funds of certain sponsoring organizations that are Type I or Type II supporting organizations.

5. There is no coordination of these proposed excise taxes with each other or with the expanded section 4958 excise taxes (discussed below). For example, a donor who is also an advisor and who is on the sponsoring organization's board of directors could be exposed to three separate section 4969 excise taxes if the donor receives a more-than-incidental benefit, adding up to a total tax rate of 60%. In addition, that same donor could be exposed to the newly expanded section 4958 excise taxes discussed below, for an additional 35%. Finally, the same person could be subject to two taxes under section 4968, for an additional 25%. The potential for exposing one person to seven penalties totaling 120% for the same transaction is excessive.

6. The section 4969 excise tax on more-than-incidental benefits would apply to the entire distribution, not just the benefit. For example, if a donor advised that a grant of \$1,000,000 be awarded to a university, and the university gave the donor football tickets worth \$1,000, the donor could be subjected to a 25% excise tax on the whole \$1,000,000, resulting in a \$250,000 penalty that is entirely out of proportion to the \$1,000 benefit. (In fact, due to the lack of coordination mentioned above, if the same person both advised the distribution and received the benefit, that person could be subjected to two 25% penalties totaling \$500,000.)

7. For the purpose of computing minimum distributions, section 4967 would impose arbitrary rules on the valuation of illiquid assets that assumes a 5% annual increase in fair market value. If any minimum distribution computation is necessary, the rules should be consistent with the existing rules that apply to private foundations. There is no apparent policy reason to introduce an unfamiliar new valuation regime instead of using well-established rules already in place.

8. Sections 4967-4969 would treat donor-advised funds more harshly than private foundations are treated. The section 4968 and section 4969 excise tax rates are much higher than their private foundation

counterparts even as increased by other provisions of S. 2020. Moreover, there is no accommodation such as the option to exercise expenditure responsibility to relieve the requirement that grants can be made only to organizations described in section 170(b)(1)(A). There is no apparent reason to subject donor-advised funds to more onerous rules than private foundations.

Section 332: Prohibited transactions

Section 332 of S. 2020 would expand the application of the intermediate sanctions excise taxes under Code section 4958 in two respects. First, a donor-advised fund's donors, advisors, investment advisors, their families, and certain 35% controlled entities would be specifically included as "disqualified persons" with respect to the sponsoring organization. As a general principle the expansion of the application of the section 4958 excise taxes to donor-advised funds in this way is sound tax policy. However, this provision deserves further scrutiny in the light of the broad definition of donor-advised funds in S. 2020 and the addition of investment advisors as disqualified persons. Investment advisors who serve no other role with a charity are generally not considered disqualified persons in applying the section 4958 excise taxes, and there is no apparent reason to treat them differently where they are providing investment advice to a public charity with respect to a donor-advised fund.

Second, section 332 would amend Code section 4958(c)(2) to include "Special Rules for Donor-advised Funds Owned by Sponsoring Organizations," and specifically to provide: "(A) the term "excess benefit transaction" includes *any* grant, loan, compensation, or other payment from such fund to a person described in [section 4958(f)(1)(D)]." Section 4958(f)(1)(D), as amended by S. 2020, expands the definition of "disqualified person" for purposes of section 4958 (excess benefit transactions) to include the donor (and related parties) of a donor-advised fund. This treatment of payments from donor-advised funds as automatic excess benefit transactions is inconsistent with the application of the section 4958 excise taxes in other situations, where the reasonableness of a transaction is a defense. Moreover, as to compensation, it would treat sponsoring organizations and their disqualified persons much more harshly than private foundations and their disqualified persons. This would create more traps for the unwary, especially given the broad definition of donor-advised fund.

If this automatic penalty provision is retained and enacted, it should be revised. New subparagraph section 4958(f)(1)(D) would not limit the application of section 4958 to transactions involving the specific donor-advised fund. As a result, it would extend the application of the *general* rules of section 4958 to *any* transaction between a public charity sponsoring organization and a donor of a donor-advised fund, even if the transaction does not involve any use of the assets of the fund. The provision would significantly expand the number of disqualified persons subject to section 4958 and would create substantial administrative and monitoring problems for public charity sponsoring organizations that have a large number of donor-advised funds.

To avoid this result, 4958(f)(1)(D), as amended by S. 2020, should be revised to read as follows:

"(D) **only for purposes of section 4958(c)(2)**, any person who is described in paragraph (7) with respect to a sponsoring organization (as defined in section 4967(g)(1))."

To address the unusual case of donor-advised funds maintained by private foundations, section 332 of S. 2020 would also amend the definition of a disqualified person for purposes of the private foundation excise taxes to include a donor-advised fund's donors, advisors, investment advisors, their families, and certain 35% controlled entities. This would be consistent in principle with expanding the scope of the section 4958 excise taxes for sponsoring organizations that are public charities. However, the few reported abuses with respect to donor-advised funds appear primarily, if not exclusively, to involve public charities, not private foundations. In any event, the existing private foundation rules at section 4945 regarding taxable expenditures already impose penalties on any distribution that is not for a charitable purpose, regardless of whether the recipient is a disqualified person. The private foundation excise taxes are already considered onerous by many, and absent a showing that they are inadequate to deal with any donor-advised fund issues that may arise in the private foundation context, expanding their reach and complexity does not seem warranted.

Section 333: Treatment of charitable contribution deductions to donor-advised funds

Section 333 of S. 2020 would deny income, gift and estate tax deductions for contributions that are to be maintained in a donor-advised fund if any of the following three conditions exist: (1) the sponsoring organization is a Type III supporting organization, (2) the donor does not receive an acknowledgement from the sponsoring organization that it has exclusive legal control of the assets contributed, or (3) the sponsoring organization is non-charitable (e.g., war veterans post or fraternal society). Section 333 would further direct the Treasury to extend by regulation the denial of deductions for contributions to certain Type I and Type II supporting organizations.

The denial of income, gift and estate tax deductions for contributions to donor-advised funds maintained by Type III supporting organizations (and some Type I and II supporting organizations) is very questionable. This could result in the elimination of new Type III supporting organizations to the extent they are swept into the broad definition of donor-advised funds and sponsoring organizations. This should be compared to Congress' approach to private foundations, where donors have more control than they do over donor-advised funds and Type III supporting organizations. For private foundations, Congress has provided lower deduction limits for income tax purposes, not the elimination of the deduction altogether. More important, contributions to private foundations are entitled to full gift and estate tax deductions. There is no apparent policy reason to treat Type III supporting organizations with donor-advised funds so much more harshly than private foundations.

Section 333's denial of income, gift and estate tax deductions where the donor fails to receive the required written acknowledgement of exclusive control is also very questionable. Although such a requirement is consistent with the Panel on the Nonprofit Sector's recommendations, the broad definition of donor-advised fund in S. 2020 could reach unintended restricted gifts where the donor has some voice in the use, or even the investment, of a contribution. It is one more trap for the unwary. To be safe, charities are likely to include the written acknowledgement of exclusive control in every gift receipt they issue, regardless of whether it involves a donor-advised fund, which may defeat the purpose of the provision.

Section 334: Returns of, and application for recognition of exemption by, sponsoring organizations

Section 334 of S. 2020 would require that a sponsoring organization provide more information about its donor-advised funds on its exemption application and on its annual Form 990. This is sound tax policy. However, if the definition of donor-advised fund is not more precisely drawn, charities may report so many arrangements as donor-advised funds that the information will be of limited use.

Section 334 would also extend the statute of limitations for the new excise taxes contained in section 331 of S. 2020. If a sponsoring organization failed to include any information with respect to any donor-advised fund required to be reported on any return, the limitations period for imposing the excise taxes under section 331 of S. 2020 would not expire until three years after the information was furnished to the IRS. This is a much more onerous limitations period than applies to private foundation excise taxes under Code section 6501(e)(3) and (l), where a six-year limitations period generally applies if information is omitted from a return. Again, there is no apparent policy reason for treating donor-advised funds more harshly than private foundations.

PART III: IMPROVED ACCOUNTABILITY OF SUPPORTING ORGANIZATIONS

OVERVIEW

The Senate Finance Committee Staff's Discussion Draft included proposals with respect to Type III supporting organizations. The Section of Taxation, in its Prior Comments, provided analysis and recommendations with respect to those proposals. We also note that the Panel on the Nonprofit Sector convened by the Independent Sector at the invitation of the Senate Finance Committee made detailed recommendations related to operations of Type III supporting organizations and disclosure by all supporting organizations. The supporting organization provisions in S. 2020 go far beyond the scope of the prior proposals, and there has been no meaningful opportunity for discussion of the new provisions. In particular, S. 2020 would penalize or prohibit non-abusive practices involving supporting organizations of *all* types (i.e., Types I and II supporting organizations as well as Type III organizations) for reasons that

have not been articulated. This is surprising and highly questionable, given the broad consensus that Type III supporting organizations present much greater potential for abuse than Type I and Type II organizations, which are controlled by the public charities that they support. We believe that the bill should not apply to Type I and II supporting organizations.

We further note that the concerns driving reforms to the supporting organization rules are based principally on issues of donor control. These concerns do not apply to parent organizations of healthcare systems and similar multi-entity systems of direct charitable service providers, such as student loan finance organizations, which are commonly structured as Type III supporting organizations. Any reforms to the supporting organization rules should carve out such system parent entities, or should create a separate Code section under which they would be treated as public charities, such as the section 509(a)(4) provision proposed in the Health Security Act of 1992 (copy attached).

Similarly, we note that issues of donor control do not apply to Type III supporting organizations that function as separate endowment funds of public charities and state universities. The bill's provisions designed to address donor control should be aimed only at those Type III organizations that are susceptible to abuse. We recommend that, at a minimum, consideration be given to either excluding from the provisions of S. 2020 those Type III organizations that are separate endowment funds of public charities and state universities, or to grandfathering such organizations.

Section 341: Requirements for supporting organizations

Letter from supported organizations

Section 341(b) of S. 2020 would require that a Type III supporting organization applying to the Internal Revenue Service for classification as a supporting organization attach a letter from each supported organization acknowledging that the supported organization has been designated as a supported organization. We support the objective of such a requirement. We suggest, however, that a better approach would be to direct the Secretary of the Treasury to promulgate rules in this regard rather than to dictate the precise contents of an exemption application through amendments to the Code.

Support of international charities

Under current law, supporting organizations may support international charities that are equivalent to public charities under U.S. law. Such U.S. organizations are commonly referred to as "friends of" organizations. Section 341(b) of S. 2020 would prohibit supporting organizations from supporting international charitable organizations. It would, as a result, make "friends of" organizations that support international charities ineligible for supporting organization classification. We oppose this proposal as precipitous, untimely, and without public policy justification. This provision has not been contained in prior legislative proposals concerning supporting organizations and has not been subject to any prior review and comment. Indeed, the Panel on the Nonprofit Sector and others have pointed to "friends of" organizations as an important and appropriate use of the supporting organization classification. The Section of Taxation concurs with that analysis. Supporting organization relationships with foreign charities have been permitted for decades under an early Internal Revenue Service revenue ruling explicitly allowing supporting organization classification on the basis of relationships with international charitable organizations. We have not seen evidence or even heard allegations that such supporting organizations have been subject to any particular abuse. In fact, because "friends of" supporting organizations "know their customer" so well, given their typical close working relationship with their supported organizations, we believe that such supporting organizations would be less subject to abuse than other grantmakers that fund international organizations.

Section 341(b) of S. 2020 would allow all "friends of" organizations only 180 days to convert to publicly supported charities. It is unclear whether many international "friends of" supporting organizations would be able to meet public support tests to make such a conversion. Many have elected supporting organization classification in order to be eligible to accept sporadic gifts, such as bequests that need to qualify for estate tax treaties or other occasional gifts, such as those that follow natural disasters. Thus, the organizations might not have the means or need to conduct ongoing fundraising campaigns that would be needed to meet the public-support test. The 180-day period is, moreover, a substantial and

discriminatory departure from the current rules for new section 501(c)(3) organizations seeking an advance ruling of public charity status and for existing private foundations that convert to public charity status, which are allowed five tax years to establish public support. Finally, it is unclear how the organizations will be able to prepare and submit, and how the Internal Revenue Service will be able to process the re-classification applications necessary to change from supporting organization to publicly supported public charity classification within the 180-day transition period.

Distributions to donor-advised funds

Section 341(b) of S. 2020 would prohibit a supporting organization from making a distribution to or for the use of a donor-advised fund. This provision has not been subject to prior review and comment and would needlessly prevent desirable distributions. Charitable organizations initially formed as supporting organizations under current law may make liquidating distributions to donor-advised funds held by sponsoring organizations for a variety of reasons, such as reducing administrative expenses, gaining access to the philanthropic and investment expertise of community foundations that sponsor donor-advised funds, and a desire for the greater simplicity that a donor-advised fund offers over a supporting organization. We submit that this is a desirable practice, not one to be prohibited. It is far easier for the Internal Revenue Service to regulate a limited number of organizations sponsoring donor-advised funds than a much larger number of supporting organizations. If any limitation is appropriate it should not be applied to distributions from a supporting organization to a donor-advised fund in the context of a transfer of substantially all the supporting organization's assets.

Section 343: Excess benefit transactions

Section 343(a) of S. 2020 would cause all grants, loans, compensation or other payments to a person who is a substantial contributor or a related person with respect to a supporting organization to be treated as excess benefit transactions for purposes of the intermediate sanctions rules under Code section 4958. The *full amount* of any such grant, loan, compensation or other payment would be considered the "excess benefit amount." A substantial contributor who received any such payment would accordingly be liable for an excise tax of 25% and would have to return the payment to the supporting organization. The provision would apply to all types of supporting organization, i.e., it is not limited to Type III supporting organizations.

First, as noted above in the Overview to our comments on the supporting organization provisions of S. 2020, we believe that the bill should not address operations of Type I and II supporting organizations. We support the recommendation made by the Panel on the Nonprofit Sector to prohibit payment of grants, loans and compensation by Type III supporting organizations to or for the benefit of a donor or related party. We do not support the bill's much broader prohibition applicable to Type I and Type II organizations, which are controlled by the public charities that they support. The existing intermediate sanctions law already imposes excise taxes on improper transactions involving Type I and Type II supporting organizations. We submit that S. 2020 should not go beyond the existing law with respect to such organizations.

Second, the provisions in S. 2020 are *far* broader than necessary or desirable. S. 2020 is more restrictive even than the current self-dealing provisions at Code section 4941 that apply to private foundations which, unlike supporting organizations, may be and commonly are controlled by donors or related persons. The self-dealing rules include a variety of appropriate exceptions, e.g., for reasonable compensation for certain types of services that are reasonable and necessary to further exempt purposes, public sales, and redemptions, which are not included in the proposed rule for supporting organizations. As a result, under S. 2020, an accountant or contractor who donated cash to the supporting organization of a state university, community foundation or hospital could be subject to automatic penalties for excess benefit transactions if the accountant or contractor were later paid reasonable compensation for services rendered to the supporting organization. These rules would work a severe hardship.

Finally, the bill's definition of a "substantial contributor" for purposes of the supporting organization rules would also go beyond that in the private foundation context under Code sections 4946(a)(2) and

507(d). It is possible for a person who becomes a substantial contributor under section 507(d) to terminate that status under certain circumstances. It appears that a substantial contributor under the supporting organization rule would retain that status forever. We do not see a basis for this harsher treatment.

Section 345: Treatment of amounts paid to supporting organizations by private foundations

Section 345 of S. 2020 would prohibit grants from private foundations to supporting organizations of all types. We oppose the provision as needlessly restrictive and without public policy justification. Moreover, the provision has not been subject to prior review and comment.

Section 345(a) of S. 2020 provides that a grant from a private foundation to a supporting organization would be excluded from the definition of a qualifying distribution under Code section 4942(g). Section 345(b) of S. 2020 would amend Code section 4945(d) to provide that a grant from a private foundation to a supporting organization would be a prohibited taxable expenditure, without any exceptions.

The change in the definition of a qualifying distribution would mean that such a grant would not count towards satisfying a foundation's minimum distribution requirement. As a result, most foundations simply would not make such grants. This would be an unfortunate result, particularly since many land-grant and state universities, community foundations, and hospitals hold their endowment funds in supporting organizations. No rationale has been provided to justify this new and extreme prohibition. Under the existing section 4942(g), a grant to *any* organization -- a public charity, a government unit, a for-profit corporation, a foreign organization -- is a qualifying distribution provided the grant is made for a charitable purpose. There is simply no basis for treating a supporting organization -- an organization that has been determined by the Service to be an organization described in section 501(c)(3) -- differently than all other organizations for purposes of the qualifying distribution rules.

If the basis for concern is that supporting organizations are not distributing grants received from private foundations in the course of charitable activities, section 4942(g) already contains a provision that can be used to address this concern. Specifically, when a private foundation makes a grant to another private foundation or to a controlled public charity, the grant will be a qualifying distribution only if (i) it is distributed by the grantee as a qualifying distribution within a specific time period as provided in section 4942(g)(3), and (ii) that distribution is made out of the corpus of the grantee as provided in section 4942(h). The effect of this is to require the grantee to pass the grant through for charitable purposes. While this rule is complex and sometimes deters private foundations from making grants to other private foundations, applying it to grants to supporting organizations would be preferable to excluding such grants completely from the definition of a qualifying distribution.

The proposed amendment to Code section 4945(d) that would cause a grant from a private foundation to a supporting organization to be a prohibited taxable expenditure, without any exceptions, is far too broad. Under current law, section 4945 provides that a grant by a private foundation to an organization other than a public charity is a taxable expenditure *unless* the foundation exercises expenditure responsibility under section 4945(h). Section 345(b) does not provide this option for a grant from private foundation to a supporting organization. This means that while a private foundation may make a grant for a charitable purpose to *any* other organization -- a public charity, a government unit, a for-profit corporation, a foreign organization -- it would be completely prohibited from making a grant to a supporting organization. We note that this provision has not been subject to prior review and comment, and makes no sense from a public policy perspective. A supporting organization is an entity that the IRS has determined is operated exclusively for charitable purposes under section 501(c)(3). There is no basis for prohibiting grants to such charities while allowing grants to all other organizations. In addition, this provision could adversely affect fundraising by separately incorporated endowment funds of public charities and state universities that are structured as supporting organizations for appropriate legal and programmatic reason.

Section 346: Returns of supporting organizations

Section 346 of S. 2020 would require that all supporting organizations file annual information returns, that a supporting organization indicate on its annual return what type of supporting organization it is, list

the organization(s) that it supports, and certify that it is not controlled directly or indirectly by one or more disqualified persons. A Type III supporting organization would have to indicate whether it had obtained letters from each of its supported organizations acknowledging that it is a supported organization, detailing the type of support provided, and explaining the charitable purpose furthered by the support.

We support enhanced reporting requirements for supporting organizations generally and Type III supporting organizations in particular. We have the following concerns with the bill's provisions in this area, however.

First, it is not apparent that there is any greater policy justification for requiring supporting organizations (particularly Type I and Type II supporting organizations that do not normally have annual revenues in excess of \$25,000) to file an annual information return than there is for organizations classified as public charities under the public support tests of sections 509(a)(1)/170(b)(1)(A)(vi) and 509(a)(2), which are not required to do so. We suggest that small organizations be subject to an annual notification requirement such as that contained in section 324 of S. 2020, which is applicable to all other public charities that do not normally have annual revenues in excess of \$25,000, with additional information required for notifications of supporting organizations.

Second, the requirement that a Type III supporting organization must indicate whether it has obtained letters from each supported organization detailing "the type of support provided by the supporting organization" does not accord with the manner in which many Type III organizations provide support. A Type III organization that supports multiple organizations will commonly provide support to one or two, rather than all, of its supported organizations in any given year. The Panel on the Nonprofit Sector recommended that Type III organizations be required to obtain letters from supported organization that "describe how the supporting organization has provided *or will provide support* that furthers" the supported organization's charitable purposes (emphasis added). We suggest that the Panel's language is a more appropriate formulation.

Finally, we question whether this level of detail regarding reporting requirements of Type III supporting organizations should be set out in the Code, and suggest that a better approach would be for Congress to direct the Secretary of the Treasury to promulgate regulations to address these issues.

Tax Analysts Information

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