

# PROFESSIONAL TAX & ESTATE PLANNING NOTES

July 2005

## Legislative Reform<sup>2</sup>: Chapter II

**“The Senate Finance Committee is deeply concerned about transactions with and within charitable organizations that are inappropriately exploiting charities’ tax-exempt status and that may be wrongly enriching individuals and corporations. We are considering a number of comprehensive reforms to protect charities from bad actors and strengthen their accountability to donors.”**

This September 22, 2004, letter from Senator Charles Grassley, chairman, and Max Baucus, ranking member, to the president of the Independent Sector, arrived after Finance Committee staff had released a discussion draft of legislative proposals in June and had its first of several hearings. It asked Independent Sector to put together a national panel to “consider and recommend actions that will strengthen good governance, ethical conduct and effective practice of public charities and private foundations.” The Panel on the

Nonprofit Sector was convened a month later and issued an interim report on March 1, 2005,<sup>1</sup> after the March issue of *Professional Notes* had gone to press. (That issue discussed proposals of the Senate Finance Committee staff and a later set of proposals released by the Joint Committee on Taxation in January 2005.) The Panel’s final report was issued on June 22<sup>2</sup>. This column will focus on its recommendations concerning donor-advised funds, gifts of property, and Type III supporting organizations.

The Senate Finance Committee held additional hearings in April and June, and the House Ways and Means Committee, chaired by Congressman Bill Thomas, held a hearing in April to “examine the legal history of the tax-exempt sector; its size, scope and impact on the economy; the need for congressional oversight; IRS oversight of the sector; and what the IRS is doing to improve compliance with the law.”

### ISSUES IN THIS SERIES

MARCH 2005

1 Legislative Reform:  
Chapter I

JULY 2005

2 Legislative Reform:  
Chapter II

SEPTEMBER 2005

3 Legislative Reform:  
Chapter III

<sup>1</sup> Panel on the Nonprofit Sector, “Interim Report” presented to the Senate Finance Committee, March 1, 2005 (<http://www.nonprofitpanel.org/interim/PanelReport.pdf>).

<sup>2</sup> [http://www.nonprofitpanel.org/final/Panel\\_Final\\_Report.pdf](http://www.nonprofitpanel.org/final/Panel_Final_Report.pdf)

The committee has asked for an overview of all 28 tax-exempt categories under IRC Section 501(c), noting that there are more than 1.8 million tax-exempt organizations, not including churches and religious organizations.

### Donor-Advised Funds

**Definition.** Donor-advised funds have never been defined by law, and the Panel proposes the following definition:

**A segregated fund or separately identified account owned and controlled by a sponsoring charity eligible to receive tax-deductible contributions that holds contributions received from one or more donors who, either directly or through appointed designees (“advisors”) have the privilege of advising the sponsoring charity regarding the distribution of any amounts held in the fund.**

Over the years, practices that have long been the norm at community foundations have developed into a framework of generally accepted standards, and many of the Panel’s proposals would adopt these practices through law or regulation.

As important as what is included in the definition is what is not; the Panel wanted to make sure that designated and field-of-interest funds in community foundations—which may be advised—do not get included in the legislative and regulatory proposals designed to prevent abuse of traditional donor-advised funds. It recommends that the Secretary of the Treasury be granted the regulatory authority to exclude funds:

- where the donor’s role is limited, such as a fund for which all advisors are appointed by a governmental entity or a public charity other than the charity that owns the fund (the “sponsoring charity”);

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- that benefit a single public charity or government entity, where donors are permitted to participate in, but not directly or indirectly control, the advisory committee (a designated fund);
- that have a specific purpose (a field-of-interest fund) or designated grantee (a designated fund) with multiple unrelated donors and an advisory committee that may include one or more donors, but is not controlled by any donor;
- that are owned by a private foundation; or
- that have an advisory committee that is not directly or indirectly controlled by the donor.

The Panel recommends that a charitable deduction under Code Section 170 be permitted for a gift to a donor-advised fund only if there is a written agreement that confirms both that the sponsoring charity has exclusive legal control over the fund and its assets and that neither the donor, advisors, nor related parties may receive any substantial benefit in connection with grants or other distributions from the fund. This requirement would affirm to the donors that the assets belong to the sponsoring charity and that they are not permitted to receive benefits in connection with grants from the fund.

**Minimum distribution requirement.** The Panel proposes a 5 percent minimum distribution requirement on the aggregate asset balance of all of the sponsoring charity’s donor-advised funds as of the end of the previous year, with regulations to address exceptions and determine distributions that qualify for this purpose. If a donor-advised fund fails to make grants for three consecutive years, 20 percent of the assets would be transferred to the sponsoring charity’s own unrestricted fund or to other public charities, and advisory privileges would be terminated if a donor-advised fund is inactive for five years.

### ***Grants to private foundations.***

The Panel recommends that charities be prohibited from making grants from donor-advised funds to private non-operating foundations, or to any organization that is controlled by the donor or a related party, with the further recommendation that regulations clarify that the charity may rely on donor certifications concerning control. It is not the intent to prevent a grant from a donor-advised fund to a charity on whose board the donor or advisor sits.

***Preventing personal benefit.*** Affirming existing law, charities also would be explicitly prohibited from making grants, loans, or other payments from donor-advised funds to or for the benefit of donors or advisors (such as tuition, tickets to events, and payment of legally binding pledges). In response to allegations of advised funds paying for donors to take vacations under the guise of making site visits, the Panel recommends that paying compensation to or reimbursing expenses of donors, advisors, and related parties (including fundraising expenses and costs to prepare grant recommendations) also be prohibited.

Another recommendation would prohibit grants from donor-advised funds to individuals unless made by an advisory committee that is not controlled, directly or indirectly, by the donor or any related parties. Typically, such grants are for scholarships. Generally, at community foundations, most scholarship grants are not made through donor-advised funds, but come from field-of-interest funds, where the fund agreement states that the purpose of the fund is to award scholarships. The apparent intent of this proposal is to prevent donors from controlling the selection process and benefiting themselves.

To ease administration, the Panel proposes that sponsoring charities be permitted to rely on forms used by advisors to

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recommend grants from donor-advised funds that include a certification by the advisor that the grant will not provide benefit to, or relieve an obligation of, the donor or any advisor to the fund, including the payment of a legally binding pledge. The proposal also calls for sponsoring charities to advise each grantee organization that no substantial benefit may be provided to any donor, advisors or related party other than as a

member of the charitable class of persons served by the grantee; a statement in a voucher included with the grant check would suffice.

The Panel's report recommends that donors and advisors who receive any substantial benefit in connection with a grant or other distribution from a donor-advised fund be subject to sanctions under federal tax law. In addition, it recommends a penalty on managers of a sponsoring charity who knowingly and willfully approved the payment of compensation or reimbursement of expenses to a donor, advisor, or related party from a donor-advised fund. The Panel proposes authorizing the IRS to suspend the tax-exempt status of a sponsoring charity for flagrant violations of these prohibitions.

***Reporting.*** Finally, the Panel recommends that a sponsoring charity have additional reporting requirements on its Form 990 with respect to its donor-advised funds, including:

- the number of donor-advised funds it owns,
- the aggregate value of assets held in those funds at year end,
- the total contributions to such funds, and
- the aggregate grants from such funds during the year.

### **Contributions of Property**

Raising concern about problems relating to valuing non-cash contributions and the ease (or lack thereof) of disposition of such gifts by charity, the Joint Committee on Taxation, in its January 27, 2005<sup>3</sup>

<sup>3</sup> Joint Committee on Taxation ([www.house.gov/jct](http://www.house.gov/jct)), "Options to Improve Tax Compliance and Reform Tax Expenditures"

report, proposed to limit deductions for contributions of property other than cash and publicly traded securities to the donor's basis. The Panel's Final Report considers three types of contributed property: appreciated property (other than publicly traded securities); conservation and historic façade easements; and clothing and household items. Although establishing fair market value for these gifts can be difficult, the Panel generally recommends current incentives for gifts of property be retained, because of the importance of such gifts to the charitable sector.

**Qualified appraisals.** The Panel supports retention of current tax laws that permit taxpayers to take a deduction for the fair market value of certain gifts of appreciated property, but proposes strengthening standards for qualified appraisers. The Panel proposes to tighten the definition of a qualified appraiser by imposing minimum education and experience requirements, to be determined by the IRS, or by requiring certification by a recognized appraiser organization, as well as requiring that a qualified appraiser be someone who regularly performs appraisals for compensation, and can demonstrate experience in valuing the type of property involved. Penalties for inflated gift values would be increased on *both* taxpayers who claim a tax deduction for donated property and on appraisers. Finally, the Panel recommends mandating electronic filing of the forms on which such gifts are reported by the taxpayer, as well as those filed by the charity upon sale of the gift, so that the IRS can readily match up the values.

**Conservation easements.** These qualified appraisal standards also would apply to conservation and historic façade easements. In addition, deductions for gifts of such easements would be reduced by any financial or economic benefits the taxpayer receives as a result of the

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donation, including any increase in the value of other property owned by the donor. The Panel also recommends requiring a written agreement specifying restrictions on use of the property, that the recipient charity be required to be primarily involved in environmental protection or historic preservation, and that penalties be imposed on charities that fail to enforce such easement agreements.

**Household items.** Generally, clothing and household items contributed to charity are worth less than the original purchase price. The Panel, concerned about the disincentive of a

cap, recommends that Congress take no action with respect to such contributions, and that the IRS establish clear standards for valuing such goods. Because a claimed deduction for contributions of such property over \$500 requires filing Form 8283, it is possible that taxpayers are in fact limiting deductions for such items in excess of \$500, even when property may be worth more.

### Type III Support Organizations

A supporting organization qualifies as a public charity because of its close alignment with a supported organization that is itself a public charity. Supporting organizations are used for many legitimate purposes, including insulating assets from liability and supporting only specific programs or projects of the supported entity. Supporting organizations are classified into three types, based on the nature of the involvement with the supported organization, with Type III supporting organizations having the loosest relationship with the organizations they support. A Type III supporting organization is not controlled by, or under common control with, the supported organization, but must be operated “in connection with” the supported organizations. The Senate Finance Committee proposals recommended

eliminating Type III supporting organizations altogether, as “an area of significant abuse.” One criticism has been that these support organizations are not subject to the payout requirement imposed on private foundations, and that the supported charities are not receiving benefits concomitant with the donors’ tax deductions.

Concluding that Type III supporting organizations “add value to the charitable sector that cannot be replaced by other types of organizations,” the Panel recommends that targeted anti-abuse rules be adopted to avoid throwing out good support organizations with those being used inappropriately. In order to subject the Type III supporting organization to greater oversight and ensure significant charitable expenditures each year, these recommendations include:

- requiring such an organization to include with both its application for exemption (Form 1023) and its annual Form 990 a letter from the supported organization that confirms it has agreed to be supported and describes how the supporting organization has or will provide support that furthers the charitable purposes of the supported organization;
- limiting to five the number of organizations such a supporting organization may support;
- requiring such an organization to provide each supported organization with a copy of its governing documents, a copy of its Form 990, and an annual report of its activities;
- imposing a 5 percent payout requirement; and
- prohibiting grants or other payments from the supporting organization to or for the benefit of the donor or any related party.

It appears that this last recommendation does not preclude an arm’s-length transaction between the supporting organization and the donor; otherwise, it could have the effect of precluding gifts to Type III supporting organizations of assets that would be liquidated in a sale to the donor or a family member or to the issuing company if it is controlled by the donor.

The Panel also recommends that *every* supporting

organization be required to indicate what type it is on its annual Form 990, to enable the IRS to identify Type III support organizations. In reaction to a perceived abuse where the Type III supporting organization supports a charity that is itself controlled by the same donor, the Panel recommends a prohibition on such relationships; for this purpose, “control” is intended to be greater than the “substantial influence,” under Code Section 4958, which arises when the donor serves on the board of the supported charity. The Panel also proposes that Type III supporting organizations in trust form be required to demonstrate a “close and continuous relationship” with the supported organizations.

## Conclusion

Senate Finance Committee staff have indicated that legislation will be introduced in July, but observers believe that little action will be taken for at least a year. And, as the Panel notes in its June report, effective oversight requires vigorous enforcement. These proposals cannot succeed without the allocation of necessary resources to the Internal Revenue Service.

Donor-advised funds, gifts of property, and Type III supporting organizations constitute only one-third of the Panel’s report. The next issue of *Professional Notes* will discuss other topics: reporting; governance, executive and trustee compensation; travel expense; and government oversight.

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