

### Message From The Firm

*This is our third newsletter on the Pension Protection Act of 2006, and it addresses the subjects of supporting organizations and donor advised funds. Given that these types of entities and public charities, such as the Salvation Army and The American Cancer Society, act in a similar fashion, the IRS has found that people have used these type of entities to take advantage of the tax system. The changes discussed in the following articles are designed to make supporting organizations and donor advised funds function like real public charities. And, if they don't, they will be treated as private foundations, eliminating many of the benefits.*

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## Supporting Organizations



*By Michael B. Luftman, Esq. (MichaelLuftman@Reish.com)*

Private foundations have always been restricted by virtue of certain rules known as the prohibited transaction rules, which are designed to limit the interaction between the organization and certain related parties, and they always have been further restricted as to the deduction limits with regard to charitable gifting. When one is dealing with a public charity, these restrictions do not apply. The private foundation rules, for the most part, remain unchanged by virtue of the new law. However, what has changed is what people are no longer able to do to avoid the private foundation rules. A very common technique was to set up an organization called a supporting organization which could have been done in one of three different ways. Under the various methods, the supporting organization would work in one way or another to support another organization, typically a public charity, in order to provide benefits to that organization. By virtue of the way the rules worked under the prior law, the supporting organization was not subject to the private foundation rules with regard to prohibited transactions or the lower deduction limits. Unfortunately, a variety of people and organizations took advantage of these rules in such a way that the Internal Revenue Service went to the Congress and asked that changes be made to prevent the abuses of the system

that were taking place. Those changes have been incorporated into the Pension Protection Act of 2006 and are discussed below.

### Excess Benefit Transactions

If a supporting organization makes a grant, loan, payment of compensation, or other similar payment to a substantial contributor of the organization, the substantial contributor is treated as a disqualified person for purposes of the excess benefit transaction rules, meaning that the payment is treated automatically as an excess benefit transaction. This then results in severe repercussions for the substantial contributor as well as an organization manager who participated in the transaction. In effect, the new law is recharacterizing the supporting organization as a private foundation in this circumstance. The substantial contributor is someone who gives \$5,000 to the organization. Substantial contributors also include certain members of the person's family and certain entities that are related to the person.

### Disclosure Requirements

All supporting organizations are now required to file an annual information return with the Internal Revenue Service regardless of the amount of gross receipts. The return requires that it

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## Donor Advised Funds



*By Richard Luftman, Esq. (RichardLuftman@Reish.com)*

Donor advised funds (“DAFs”) allow a taxpayer to contribute funds to a sponsoring organization while allowing the taxpayer to retain the right to advise (but not control) which organizations receive contributions from their DAF. DAFs provide taxpayers the opportunity to contribute to several different organizations with similar purposes and receive a charitable tax deduction.

DAFs have proven to be an attractive option for taxpayers with charitable intentions who do not want the costs and restrictions associated with forming and operating their own private foundation. However, as with other tax-exempt options, the rules concerning DAFs were significantly changed by the Pension Protection Act of 2006 (“Act”). The purpose of this article is to briefly discuss the changes applicable to DAFs as a result of the Act.

### Tax Imposed on Taxable Distributions

A 20 percent tax is imposed on any sponsoring organization for taxable distributions from DAFs.

A taxable distribution is any distribution from a DAF to any natural person or to any other person if the distribution is for a non-charitable purpose (i.e., other than religious, charitable, scientific, literary, etc.) or the sponsoring organization does not exercise expenditure responsibility with respect to the distribution. Expenditure responsibility is exercised by the sponsoring organization if the sponsoring organization makes reasonable efforts to establish adequate procedures to see that: (1) the grant is spent solely for the purpose for which made; (2) full and complete reports from the grantee on how

the funds are spent is obtained; and (3) full and detailed reports with respect to such expenditures are made to the IRS.

A five percent tax (capped at \$10,000) is imposed on the agreement of any fund manager to the making of a distribution from a DAF if the manager knows it is a taxable distribution.

This rule applies to tax years beginning after August 17, 2006.

### 125 Percent Excise Tax on Prohibited Benefits

A 125 percent excise tax is imposed on the advice of a donor, donor advisor, or a related person (but not an investment advisor) directing a sponsoring organization to make a distribution from a DAF that results in the person receiving, directly or indirectly, more than an incidental benefit from the distribution. The 125 percent tax is imposed on any person who recommended the distribution and on the recipient of the benefit.

A tax equal to ten percent of the prohibited benefit (capped at \$10,000) is imposed on any fund manager who agrees to the making of a distribution, knowing that the distribution would confer an improper benefit.

This rule applies to tax years beginning after August 17, 2006.

### Employer-Sponsored Disaster Relief Assistance Programs

Under new guidance issued by the IRS, the IRS excludes from the definition of a DAF any employer-sponsored disaster relief assistance program. Therefore, any contributions made from such a program to employees or members of their families would not be subject to the excise tax described above. The new guidance specifies exactly what characteristics

the program must have in order to be excepted from the rules.

### Excess Benefit Transactions of DAFs

Donors, donor advisors, related persons to donors and donor advisors, and investment advisors to DAFs, automatically are treated as disqualified persons with respect to the sponsoring organization under the excess benefit transaction rules. An excess benefit transaction means any grant, loan, compensation, or other similar payment from a DAF to a disqualified person. The amount of the tax on an excess benefit transaction is 25 percent of the amount of the excess benefit.

A tax equal to ten percent of the excess benefit (capped at \$20,000) is imposed on any fund manager who participates in the excess benefit transaction knowing that it is such a transaction, unless such participation is not willful and is due to reasonable cause.

This rule applies to transactions occurring after August 17, 2006.

### Excess Business Holdings Rules Extended to DAFs

A tax of ten percent is imposed on excess business holdings of a DAF. Excess business holdings means the amount of stock or other interest in a business which the DAF would have to dispose of to a person other than a disqualified person in order for the remaining holdings of the DAF in such enterprise to be permitted holdings. There are specific rules applicable to DAFs in order to determine if a DAF's current holdings in a business enterprise are permitted holdings.

This rule applies to tax years beginning after August 17, 2006.

### Limitation Imposed on Charitable Deduction

The Act adds limitations on the income tax deductibility of contributions to DAFs. A contribution to a sponsoring

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## Organizations

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indicate whether it is a Type I, Type II, or Type III organization. The organization must demonstrate annually that it is not controlled directly or indirectly by one or more disqualified persons through a certification on the annual information return. It is intended that a supporting organization should be able to certify that the majority of its governing body is comprised of individuals who are selected based on their knowledge or expertise in the particular field in which the supporting organization is operating or because they represent the particular community that is served by the supported public charity.

### Provisions That Apply to Type III Supporting Organizations

Due to the fact that the Internal Revenue Service felt that the Type III supporting organizations were the ones that took the most advantage of the system under prior law, several new rules have been enacted.

The Treasury is directed to promulgate new regulations in connection with payments required by Type III supporting organizations that are not functionally integrated Type III supporting organizations. The regulations shall require the organizations to make distributions of a percentage of either income or assets to the public charities they support in order to ensure that a significant amount is paid to such supported organizations. The functionally integrated Type III supporting organization is one that is not required under regulations established by the Treasury to make payments to supported organizations because the activities of the supporting organization relate to performing the functions of, or

carrying out the purposes of, the supported organizations.

The excess business holdings rules of Internal Revenue Code § 4943, which provide for special taxes, are now applied to Type III supporting organizations. This relates to entities such as corporations and partnerships that are closely held.

In general, after August 17, 2006, Type III supporting organizations may not support an organization that is not organized in the United States.

A Type III supporting organization must apprise each organization it supports of information regarding the supporting organization in order to help ensure that the supporting organization is responsive to the needs and demands of the supported organization.

A Type III supporting organization that is organized as a trust must establish to the satisfaction of the Treasury that it has a close and continuous relationship with the supported organization i.e., that the trust is responsive to the needs or demands of the supported organization.

If a Type III supporting organization accepts contributions from a person who controls directly or indirectly either alone or together with others the governing body of a supported organization of the supporting organization and certain related persons as well, then the supporting organization is treated as a private foundation for all purposes.

A non-operating foundation may not count as a qualifying distribution that will prevent taxation under Internal Revenue Code § 4942 amounts that are paid to a Type III supporting organization that is not a functionally integrated Type III supporting organization, or any other supporting organization if a disqualified person with respect to the founda-

tion directly or indirectly controls the supporting organization or a supported organization of such supporting organization. Any amount that does not count as a qualifying distribution under this rule is treated as a taxable expenditure under Internal Revenue Code § 4945 which will then lead to special taxes.

### Mandated Study

Congress has directed the Treasury to conduct a study with regard to supporting organizations to determine whether the amount and availability of the income, gift, or estate tax charitable deductions allowed for charitable contributions are appropriate considering the use of contributed assets or the use of the assets of those organizations for the benefit of the person making the charitable contribution (or a related person).

### Internal Revenue Service Guidance

The Internal Revenue Service, in following up on the Pension Protection Act of 2006, has started to issue guidance with regard to the rules discussed above. The Internal Revenue Service had lobbied the Congress for better capabilities to enforce the spirit of the law, and the Congress gave the Internal Revenue Service what it wanted. Thus, the Internal Revenue Service is now moving forward.

### Closing Comment

It is probably apparent by now that the rules passed by the Congress are designed to prevent abuses. It is probably also very apparent that there are a great many technical rules, some of which have been described herein, that must be addressed. Anyone who is involved with a support organization or contemplates getting involved with a support organization will need to plan carefully before any steps are taken. ♦

## Advised Funds

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organization for maintenance in a DAF is not deductible for income tax purposes if the sponsoring organization is a veterans organization, a fraternal society, or a cemetery company. In addition, no deduction will be allowed for such contributions if the sponsoring organization is a Type III supporting organization (with one exception).

This rule also applies to estate and gift tax charitable deductions, except that cemetery companies are excluded from the list of prohibited recipient organizations.

This rule applies to contributions made after the date which is 180 days after August 17, 2006.

### New Substantiation Rule

An otherwise allowable contribution to a DAF will be allowed only if the taxpayer obtains written acknowledgment of the DAF's control of the assets (and otherwise satisfies the existing substantiation requirements). A donor must obtain a contemporaneous written acknowledg-

ment from the sponsoring organization providing that the sponsoring organization has exclusive legal control over the assets contributed.

This rule applies to contributions made after the date which is 180 days after August 17, 2006.

### New Reporting Rules for Sponsoring Organizations

Sponsoring organizations are now required to include in their annual returns (1) the total number of DAFs owned by the organization, (2) the aggregate value of assets held in these DAFs as of the end of the tax year, and (3) the aggregate contribution to and grants from such DAFs during the tax year.

A new sponsoring organization must list on its application for tax exempt status (IRS Form 1023) whether the organization maintains or intends to maintain DAFs. If so, the organization must describe the manner in which it holds, or will hold, such DAFs.

The rules relating to annual returns of sponsoring organizations apply to returns filed for tax years ending after August 17, 2006. The rules relating to matters

included on tax-exempt status application apply to organizations applying for tax-exempt status after August 17, 2006.

### Study Mandated for DAFs

The Act directs the Treasury Department to undertake a study of the organization and operation of DAFs and to report its findings to both the House Ways and Means Committee and the Senate Finance Committee within one year after August 17, 2006. The report must consider, among other things, the appropriateness of the use of contributed assets, the retention of advisory privileges by a donor, and whether DAFs should be required to distribute a specified amount for charitable purposes.

### Planning Point

As one can see, these rules are extremely technical. These rules are clearly designed to discourage abuse of tax-exempt entities. It is critical that anyone who is currently working with a DAF, or who is considering working with a DAF, understand these rules or risk running afoul of the severe and expensive penalties for non-compliance. ❖

## Around the Firm

Mark Terman will present "When The New Year Ball Drops: Will You Be Ready To Catch It?" to the Professionals in Human Resources Association on December 14th. Robin Gilden and Stephen Halper are panelists at a CEB Program on Forming and Operating Limited Liability Companies in Anaheim and Los Angeles on January 13th and 27th. Robin is a part of the planning committee for the USC 2007 Tax Institute conference being held on January 22nd through the 24th.

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