

The Pension Protection Act of 2006 and Nonprofit Reforms

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The Pension Protection Act of 2006, formerly known as H.R. 4, became law on August 17, 2006.¹ The Act could have been more appropriately called the Miscellaneous Reform Act of 2006. In addition to significant reforms to existing pension laws to protect the pensions of working Americans, the Act includes other reforms such as modernizing the Tax Court, amending the Federal Mine Safety and Health Act of 197 and implementing or modifying duties and tariffs on imported goods. Of most interest to those working in the nonprofit field is Title XII, Provisions Relating to Exempt Organizations.

Highlights of the Nonprofit Reforms in the Pension Protection Act of 2006

With the enactment of this new law, Senator Grassley, Chairman of the Senate Committee on Finance, has achieved a partial victory in his campaign to reform nonprofit organizations. Some of his personal gripes about the nonprofit sector have been addressed:

- Tax deductions for the donation of taxidermy property (a work of art which is the reproduction or preservation of a dead animal) are limited by Sec. 1214.
- Credit counseling organizations face stricter standards and requirements under Sec. 1220.
- Organizations that are not subject to filing a Form 990 information return have new reporting obligations under Sec. 1223.
- Organizations that file a 990-T for unrelated business income will now have to make the return available for public inspection and copying (Sec. 1225).
- Donations of used household goods and clothing that are not in good condition are disallowed under Sec. 1216.
- The federal government will now notify state officials when the IRS takes adverse action against certain charitable organizations (Sec. 1224).
- Donor advised funds face tough new standards for deductibility of charitable contributions and increased penalties for excess benefit transactions (Sec. 1231-1235).
- Supporting organizations also face increased distribution limits, increased penalties for excess benefit transactions and new reporting requirements (Sec. 1241-1245).

Congress was not wholeheartedly committed to some of these reforms as evidenced by the many provisions that expire after 2007:

- The provision allowing taxpayers to withhold from their gross income up to \$100,000 in withdrawals from IRAs for donations to charity sunsets after 2007 (Sec. 1201).
- Tax deductions for donations of food inventory (Sec. 1202) and text books (Sec. 1204) also end after 2007.
- The increased deductions for qualified conservation contributions and certain contributions by farmers and ranchers end after 2007 (Sec. 1206).

The Secretary of the Treasury is directed to report back to Congress on three provisions:

- Sec. 1205 (special rule for the tax treatment of certain payments of interest, rents, annuities, or royalty payments);

¹ Public Law No: 109-280

- Sec. 1211 (ownership interest in certain life insurance, annuity, or endowment contracts); and
- Sec. 1226 (organization and operation of donor advised funds).

Specific Provisions

Charitable Giving Incentives

Congress is testing new charitable giving incentives. Most are only effective for one to two years until their impact can be analyzed.

Taxpayers can now take up to \$100,000 from their IRA, distribute it to charities and not count it in their gross income. This provision is only good for 2006 and 2007 but it may be extended if it proves to be popular.

S corporations are encouraged to make charitable contributions through more favorable tax treatment of shareholders. Corporations that donate book inventories to public schools are entitled to increased deductions. Non-corporate taxpayers may make tax deductible contributions of food inventory.

The Act rewards efforts to protect family farms and ranches from development. Individual taxpayers are entitled to an increased tax deduction (50% of taxpayer contribution base) for donating real property to a charitable organization exclusively for conservation purposes (a qualified conservation contribution). This tax deduction increases to 100% for contributions by certain farmers or ranchers. There is a 15-year carryforward of unused deduction amounts and an increased tax deduction (and 15-year carryover of such tax deduction) for qualified conservation contributions made by corporate farmers and ranchers. These provisions expire after 2007.

General Reforms

Prior to the Pension Protection Act of 2006, organizations with annual incomes under \$25,000 did not have any annual reporting requirement at the federal level. Starting in 2007, these organizations will have to annually report to the IRS, in electronic form, certain basic information about the organization which will become publicly available. This notice will include: the legal name of the organization; any name under which the organization operates or does business; the organization's mailing address and Internet web site address (if any); the organization's taxpayer identification number; the name and address of a principal officer; and evidence of the continuing basis for the organization's exemption from filing a Form 990. Notice of termination must be filed with the IRS when the organization goes out of existence. Failure to file the 990 or provide this new notice to the IRS for three consecutive years results in the automatic revocation of exempt status. Organizations may apply to have their exempt status reinstated. The reinstatement can be retroactive to the date of revocation for reasonable cause shown.²

² Section 1223.

Sec. 1212 increases penalties on charitable organizations, including private foundations, for: (1) self-dealing and excess benefit transactions; (2) failure to distribute income; (3) excess business holdings; (4) investments which jeopardize charitable purpose; and (5) taxable expenditures (e.g., political activities). The excise tax increases from 5% to 10% and the limit for penalties on managers for prohibited activities double from \$5,000 to \$10,000.

Sec. 1213 modifies requirements for the tax deduction for charitable contributions of easements on buildings in registered historic districts to require such easements to preserve the entire exterior of the building and to prohibit any change that is inconsistent with the historical character of such exterior.

Tax-exempt organizations which acquire a direct or indirect interest in certain life insurance, annuity, or endowment contracts must file informational returns during a specified two-year period. Penalties are imposed on such organizations for failure to file the required information.³

There are new rules for the recapture of tax benefits for charitable contributions of tax-exempt use property which is not used for charitable purposes. The reporting requirements relating to the disposition of charitable deduction property by a donee are modified. There is a new \$10,000 penalty for the fraudulent identification of tax-exempt use property. These new rules apply to the donation of tangible personal property intended by the donor to be used by the donee for its tax-exempt purposes.⁴

Taxpayers who clean out their closets and basements are no longer guaranteed a deduction when they donate those used items. Tax deductions are not allowed for donations of clothing or household items that are not in good used condition or better. "Household items" is defined to include furniture, electronics, appliances, linens, and other similar items, but excludes food, paintings, antiques and other objects of art, jewelry and gems, and collectibles.⁵

The recordkeeping requirements for charitable contributions of monetary gifts have been modified. Taxpayers must now be able to document their donation through bank records or written confirmation from the donee organization. The written confirmation must show the name of the donee organization and the date and amount of the contribution. This change is effective with the 2007 tax year.⁶

There are increased penalties for substantial and gross overstatements of valuations of charitable deduction property. The reasonable cause exception for gross misstatements has been eliminated. A penalty is imposed on appraisers for intentional misstatements of appraisal values and there are new definitions relating to appraisers and appraisals.⁷

³ Section 1211.

⁴ Section 1215.

⁵ Section 1216.

⁶ Section 1217.

⁷ Section 1219.

There are new standards and requirements for tax-exempt credit counseling organizations. Anyone providing advice to these organizations should read the new law in detail. To qualify for tax exemption, credit counseling organizations must:

- (i) provide credit counseling services tailored to the specific needs and circumstances of consumers;
- (ii) not make any loans to debtors (other than loans with no fees or interest) and may not negotiate the making of loans on behalf of debtors;
- (iii) provide services for the purpose of improving a consumer's credit record, credit history, or credit rating only to the extent that such services are incidental to providing credit counseling services; and
- (iv) not charge a separately stated fee for services for the purpose of improving any consumer's credit record, credit history, or credit rating.

Credit counseling organizations may not refuse to provide credit counseling services to a consumer due to the inability of the consumer to pay, the ineligibility of the consumer for debt management plan enrollment, or the unwillingness of the consumer to enroll in a debt management plan. Any fees charged to a consumer for services must be reasonable and fees should be waived if the consumer is unable to pay. There are restrictions on how fees can be calculated and strict rules about the composition of the organization's board of directors.⁸

The IRS will now make available to state officials on request information about charitable organizations to aid in the enforcement of state laws. Information that may be disclosed includes:

- a notice of proposed refusal to recognize such organization as an organization described in section 501(c)(3) or a notice of proposed revocation of such organization's recognition as an organization exempt from taxation;
- the issuance of a letter of proposed deficiency of tax; and
- the names, addresses, and taxpayer identification numbers of organizations which have applied for recognition as organizations described in section 501(c)(3).

The IRS may make the returns filed by these organizations available to state officials for inspection. Even if the state official does not request this information, the Secretary of the Treasury is authorized to provide information to state officials if the "Secretary determines that such returns or return information may constitute evidence of noncompliance under the laws within the jurisdiction of the appropriate State officer."⁹

Tax-exempt charitable organizations that file Form 990-T (unrelated business income tax returns) must now make these returns available for public inspection and copying. This adds the 990-T to the list of documents that must be made available for public inspection and copying under the same terms and conditions previously in effect.¹⁰

Donor Advised Funds

A "donor advised fund" is defined as a separately identified fund which is owned and controlled by a sponsoring organization and which permits a donor to have advisory privileges as to the distribution or investment of fund assets. A "sponsoring organization" is defined as a tax-

⁸ Section 1220.

⁹ Section 1224.

¹⁰ Section 1225.

exempt organization which is not a private foundation and which maintains one or more donor advised funds.

New penalty taxes are imposed on sponsoring organization relating to certain distributions made from donor advised funds. Taxable distributions from a donor advised fund will result in a 20% excise tax on supporting organizations and a 5% tax on fund management. The amount of the tax is limited to \$10,000 for any one taxable distribution. There are also new penalty taxes for excess benefit transactions involving donor advised funds and excess benefit holdings of donor advised funds.

Individuals and estates face new limits on the tax deductibility of charitable contributions to donor advised funds. Taxpayers will have to obtain a contemporaneous written acknowledgment from the sponsoring organization of the donor advised fund that such organization has exclusive legal control over the assets contributed. This provision goes into effect March 20, 2007 (181 days after the Act became law).

Penalties applicable to tax-exempt organizations for excess benefit transactions involving donor advised funds are extended as are the penalties applicable to private foundations for excess benefit holdings of donor advised funds.

A supporting organization must now report each year: (1) the total number of its donor advised funds; (2) the aggregate value of assets held in such funds; and (3) the aggregate contributions to, and grants made from, such funds.¹¹

Supporting Organizations

Supporting organizations face new requirements relating to distributions and responsiveness to supported organizations. Type III supporting organizations must provide to each supported organization information (yet to be determined by the IRS) to ensure that such organization is responsive to the needs or demands of the supported organization. There will be new payout rules too.

Penalties applicable to tax-exempt organizations for excess benefit transactions involving supporting organizations are extended as are the penalties applicable to private foundations for excess benefit holdings of supporting organizations. New limits are imposed on distributions and taxable expenditures made by nonoperating private foundations to supporting organizations.

Supporting organizations have new reporting requirements. They now must list the organization(s) they support and certify that they still meet the definition of a supporting organization.¹²

¹¹ Section 1231 to 1235.

¹² Section 1241 to 1245.

Summary of the Nonprofit Reforms in the Pension Protection Act of 2006

Title XII: Provisions Relating to Exempt Organizations¹³

Subtitle A: Charitable Giving Incentives

Sec. 1201 amends the Internal Revenue Code (IRC) to exclude from the gross income of certain individual retirement account (IRA) holders up to \$100,000 of their distributions from such accounts made for charitable purposes. This tax exclusion is only available for the 2006 and 2007 tax years. It also increases the penalties for the failure of split-interest trusts and trusts claiming certain tax deductions for charitable contributions to file the required informational returns.

Sec. 1202 extends through 2007 the provisions allowing non-corporate taxpayers to make tax deductible contributions of food inventory.

Sec. 1203 provides that the amount of an S corporation shareholder's basis reduction in the stock of such corporation due to a charitable contribution made by the corporation will be the shareholder's pro rata share of the adjusted basis of the contributed property.

Sec. 1204 extends through 2007 the increased tax deduction for corporate contributions of book inventories to public schools.

Sec. 1205 sets forth a special rule for the tax treatment of payments of interest, rents, annuities, or royalty payments made to a tax-exempt organization which has a controlling interest in the entity making such payments. This special rule terminates after 2007. The Secretary of the Treasury must report to the Senate Finance Committee and the House Ways and Means Committee on the effectiveness of the Internal Revenue Service (IRS) in administering this tax provision.

Sec. 1206 allows individual taxpayers an increased tax deduction (50% of taxpayer contribution base) for qualified conservation contributions (real property donated to a charitable organization exclusively for conservation purposes). This tax deduction increases to 100% for contributions by certain farmers or ranchers. There is a 15-year carryforward of unused deduction amounts and an increased tax deduction (and 15-year carryover of such tax deduction) for qualified conservation contributions made by corporate farmers and ranchers. These provisions terminate after 2007.

Sec. 1207 exempts tax-exempt blood collector organizations from: (1) the excise tax on diesel and special motor fuels; (2) the manufacturer's excise tax; (3) the communication excise tax; and (4) the excise tax on heavy vehicles.

¹³ Adapted from the summary of the Pension Protection Act of 2006 prepared by the Library of Congress.

Subtitle B: Reforming Exempt Organizations

Part I: General Reforms

Sec. 1211 requires tax-exempt organizations which acquire a direct or indirect interest in certain life insurance, annuity, or endowment contracts to file informational returns during a specified two-year period. Penalties are imposed on such organizations for failure to file the required information. It directs the Secretary of the Treasury to study the use of such contracts by tax-exempt organizations and to report to the Senate Finance Committee and the House Ways and Means Committee.

Sec. 1212 increases penalties on charitable organizations, including private foundations, for: (1) self-dealing and excess benefit transactions; (2) failure to distribute income; (3) excess business holdings; (4) investments which jeopardize charitable purpose; and (5) taxable expenditures (e.g., political activities). The excise tax increases from 5% to 10% and the limit for penalties on managers for prohibited activities double from \$5,000 to \$10,000.

Sec. 1213 modifies requirements for the tax deduction for charitable contributions of easements on buildings in registered historic districts to require such easements to preserve the entire exterior of the building and to prohibit any change that is inconsistent with the historical character of such exterior.

Sec. 1214 disallows enhanced tax deductions for charitable contributions of taxidermy property (a work of art which is the reproduction or preservation of a dead animal).

Sec. 1215 sets forth rules for the recapture of tax benefits for charitable contributions of tax-exempt use property which is not used for charitable purposes. The reporting requirements relating to the disposition of charitable deduction property by a donee are modified. There is a new \$10,000 penalty for the fraudulent identification of tax-exempt use property.

Sec. 1216 disallows a tax deduction for clothing or household items that are not in good used condition or better. Defines "household items" to include furniture, electronics, appliances, linens, and other similar items, but excludes food, paintings, antiques and other objects of art, jewelry and gems, and collectibles.

Sec. 1217 modifies recordkeeping requirements for charitable contributions of monetary gifts to require bank records for such contributions or written confirmation from the donee organizations.

Sec. 1218 requires a tax-exempt organization which receives a donation of a fractional interest in an item of tangible property to take actual possession of such item for the portion of the year corresponding to the organization's percentage interest in such item.

Sec. 1219 increases penalties for substantial and gross overstatements of valuations of charitable deduction property. A penalty is imposed for intentional misstatements of appraisal values and there are new definitions relating to appraisers and appraisals.

Sec. 1220 establishes standards and requirements for tax-exempt credit counseling organizations.

Sec. 1221 revises the definitions of private foundation gross investment income and capital gain net income for purposes of the excise tax on such income.

Sec. 1222 defines "convention or association of churches" to include individuals (with or without voting rights) as well as churches.

Sec. 1223 imposes certain reporting requirements on exempt organizations not currently required to file information returns (e.g., organizations with gross receipts of less than \$25,000).

Sec. 1224 authorizes the Secretary of the Treasury to notify state officials of adverse actions taken by the IRS against certain charitable organizations.

Sec. 1225 permits public disclosure of unrelated business income tax returns filed by tax-exempt charitable organizations.

Sec. 1226 Directs the Secretary to study the organization and operation of donor advised funds and report to the Senate Finance Committee and the House Ways and Means Committee on such study.

Part 2: Improved Accountability of Donor Advised Funds

Sec. 1231 imposes a 20% excise tax on supporting organizations (5% tax on fund management) for making taxable distributions from a donor advised fund. The amount of such tax is limited to \$10,000 for any one taxable distribution.

This section defines "sponsoring organization" as a tax-exempt organization which is not a private foundation and which maintains one or more donor advised funds. A "donor advised fund" is defined as a separately identified fund which is owned and controlled by a sponsoring organization and which permits a donor to have advisory privileges as to the distribution or investment of fund assets.

The Secretary of the Treasury is authorized to exempt a fund from treatment as a donor advised fund under certain conditions. It also imposes penalty taxes on prohibited benefits resulting from certain distributions made from donor advised funds.

Sec. 1232 extends penalties applicable to tax-exempt organizations for excess benefit transactions involving donor advised funds.

Sec. 1233 extends penalties applicable to private foundations for excess benefit holdings of donor advised funds.

Sec. 1234 limits the tax deductibility of charitable contributions made to donor advised funds by individuals, estates, and donors of gifts.

Sec. 1235 requires a supporting organization to report for its taxable year: (1) its total number of its donor advised funds; (2) the aggregate value of assets held in such funds; and (3) the aggregate contributions to, and grants made from, such funds.

Part 3: Improved Accountability of Supporting Organizations

Sec. 1241 sets forth requirements for supporting organizations relating to distributions and responsiveness to supported organizations.

Sec. 1242 extends penalties applicable to tax-exempt organizations for excess benefit transactions involving supporting organizations.

Sec. 1243 extends penalties applicable to private foundations for excess benefit holdings of supporting organizations.

Sec. 1244 limits distributions and taxable expenditures made by nonoperating private foundations to supporting organizations.

Sec. 1245 sets forth reporting requirements for supporting organizations.