SUMMARY OF CHANGES TO TAX RULES GOVERNING DONOR ADVISED FUNDS AND SUPPORTING ORGANIZATIONS INCLUDED IN H.R. 4, THE PENSION PROTECTION ACT OF 2006

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Background. Some colleges and universities operate donor advised funds and/or supporting organizations to ease administration of large donations. This document explains provisions in H.R. 4 impacting these entities that are created by tax-exempt organizations, including colleges and universities.

A donor advised fund allows people to give money, stock, and other assets to special accounts. Donors may claim a deduction at the time of the gift, and the institution administering the fund gains full control over the contribution. The institution is not legally bound to follow the advice of the donor, but can make grants to itself, or other tax-exempt organizations, such as an alumni association, based on donor recommendations.

Supporting organizations are charitable entities established solely to provide operational or financial support to one or more other exempt organizations. The category can cover many types of entities, including university foundations that raise funds for an institution and/or hold endowment funds. A supporting organization must have one of three relationships with the supported organizations--set up as either Type I, II, or III--all of which are intended to ensure that the supporting organization is responsive to the needs or demands of the supported organization and involved in its operations.

Treasury regulations define Type I supporting organizations as "operated, supervised, or controlled by the supported organizations. Type II supporting organizations are "supervised or controlled in connection with" the supported organization. Type III supporting organizations are "operated in connection with" the supported organization—the least formal of the three types. Many supporting organizations run by colleges and universities are Type III.

The rules and reforms for supporting organizations in H.R. 4 are aimed at preventing abuses, such as where a donor gives money to a supporting organization, takes the tax deduction, then receives a loan for the donated amount, often routed through one or more intermediary organizations.

Provisions in H.R. 4 Related to Donor Advised Funds:

Treasury Study Commissioned. The bill directs Treasury to conduct a one-year study to determine whether charitable contributions deductions are "appropriate" for gifts to donor-advised funds and supporting organizations in consideration of the use of the contributed assets or the use of the assets of the organization to benefit the person making the gift or a related

person; whether donor advised funds should be subject to minimum distribution requirements; whether retention of advisory rights by donors is consistent with the treatment of the transfers as completed gifts; and whether these issues are of concern with other forms of charities or charitable donations.

Excise Taxes Relating to Donor Advised Funds. H.R. 4 adds two new Code sections, 4966 and 4967, defining "donor advised fund" and imposing excise taxes on taxable distributions and on prohibited transactions of donor advised funds. Previously, the tax code did not contain a definition of a "donor advised fund" or otherwise deal with donor advised funds directly.

Definition of Donor Advised Fund. New section 4966 defines a "donor advised fund" as a fund or account that is: (1) separately identified by reference to contributions of a donor or donors; (2) owned and controlled by a sponsoring organization; and (3) with respect to which a donor (or any person appointed or designated by such donor (a "donor advisor") has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in the separately identified fund or account by reason of the donor's status as a donor. All three prongs of the definition must be met for a fund or account to be treated as a donor advised fund.

Exceptions to Definition. The term donor-advised fund does not include any fund or account that makes distributions only to a single identified organization or governmental entity. The definition also does not apply to a fund or account that makes grants to individuals for travel, study, or other similar purposes if the fund is advised by a committee, all of the members of which are appointed by the sponsoring organization, and the committee is not controlled by the donor or persons appointed by the donor, and if the grants are awarded using an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the sponsor's board and that meets the requirements for similar grants by private foundations. Finally, the Secretary of the Treasury is authorized to exempt a fund or account from the definition, provided the fund is either advised by a committee not controlled by the donor or is a fund benefiting a single charitable purpose.

Prohibited Distributions (Grants). Donor advised funds are prohibited from making grants to individuals; to nonoperating private foundations; to any entity if the payment is not for a charitable purpose; to Type III supporting organizations (except for those that are "functionally integrated"); and grants to Type I or II supporting organizations if the donor or advisor controls a supported organization or the Secretary determines by rule that a distribution is inappropriate; and to organizations not described in Code section 170(b)(1)(A) without the exercise of expenditure responsibility.

Excise Tax on Prohibited (Taxable) Distributions. New Code section 4966 imposes two separate excise taxes on prohibited distributions -- one on the sponsoring organization equal to 20 percent of the amount of the distribution and another tax on a fund manager who agrees to make the distribution, knowing that it is a taxable transaction, equal to 5 percent of the distribution, with a maximum amount of $10,000.

Prohibited Benefits. New Code section 4966 also imposes excise taxes if the donor, advisor or related parties receive more than incidental benefits from a donor-advised distribution from the fund or account. The excise tax equals 125 percent of the amount of the benefit, and can be imposed on the person who recommends the grant or the person who receives the benefit. Fund managers who approve the distribution are subject to a penalty of 10 percent if they knew the distribution would result in an impermissible benefit.

Excess Benefit Transactions Involving Donor Advised Funds and Sponsoring Organizations. H.R. 4 amends the excess benefit transaction rules (sometimes referred to as intermediate sanctions) to include special rules for donor advised funds. The special rules prohibit grants, loans, compensation and similar payments from donor-advised funds to donors, advisors and related parties, and any receipt of such payments is automatically an excess benefit transaction subject to penalty taxes under Code section 4958 (intermediate sanctions). Code section 4958 imposes an initial (first-tier) excise tax of 25 percent of the amount involved and requires that the amount involved be repaid. Under the new rules, the amount repaid may not be held in any donor-advised fund.

Excess Business Holdings of Donor Advised Funds. The bill applies the excess business holdings rules applicable to private foundations under Code section 4943 to donor advised funds. In applying these rules to donor advised funds, the term "disqualified person" is defined to mean, with respect to the donor advised fund, a donor, donor advisor, a member of the family of a donor or donor advisor, or a 35 percent controlled entity of any such person.

Limitations on Deductibility of Contributions to Donor Advised Funds. H.R. 4, provides that certain contributions to a sponsoring organization for maintenance in a donor advised fund are not deductible as a charitable contribution. In addition, contributions to a sponsoring organization for maintenance in a donor advised fund are not eligible for a charitable deduction for income, gift, or estate tax purposes if the sponsoring organization is a "Type III" supporting organization (an organization that is operated "in connection with" a publicly supported organization, as defined in Treas. Reg. sec. 1.509(a)-4(f)(2)), other than a functionally integrated Type III supporting organization). A functionally integrated Type III supporting organization is a Type III supporting organization that is not required under regulations to make payments to supported organizations due to the activities of the organization related to performing the functions of, or carrying out the purposes of, such supported organizations. For example, a university foundation that conducts fundraising and investment activities on behalf of the university would be functionally integrated.

Returns and Applications for Recognition of Exemption By Sponsoring Organizations. H.R. 4 requires each sponsoring organization to disclose on its information return: (1) the total number of donor advised funds it owns; (2) the aggregate value of assets held in those funds at the end of the organization's taxable year; and (3) the aggregate contributions to and grants made from those funds during the year. Additionally, when applying for recognition of tax-exempt status, an organization must disclose to the IRS whether it intends to maintain donor advised funds.

Supporting Organizations

Requirements for Supporting Organizations. H.R. 4 imposes additional requirements that must be met for certain supporting organizations to qualify for public charity status. The provision requires Type III supporting organizations to provide such information as Treasury requires to each supported organization to ensure that the supporting organization is responsive to the needs or demands of the supported organization. The provision also prohibits Type III supporting organizations from supporting a foreign organization, with a three-year transition rule for existing organizations. These provisions became effective on the date of enactment.

Type I and III supporting organizations will fail to qualify as supporting organizations if they accept a gift from a person who directly or indirectly controls a supported organization. With respect to charitable trusts that are Type III supporting organizations, the charitable trust will not be considered to be operated "in connection with" the supported organization(s) (i.e., meet the "responsiveness test") solely because it is a charitable trust under state law, the supported organization is a beneficiary of the trust, or because the supported organization has the power to enforce the trust and compel an accounting. This provision becomes effective one year after the date of enactment for trusts in existence on the date of enactment; otherwise, it is effective on the date of enactment.

Excess Benefit Transactions Involving Supporting Organizations. H.R. 4provides that if a supporting organization (Type I, Type II, or Type III) makes a grant, loan, payment of compensation, or other similar payment to a substantial contributor (or person related to the substantial contributor) of the supporting organization, for purposes of the excess benefit transaction rules under Code section 4958, the substantial contributor is treated as a disqualified person and the payment is treated automatically as an excess benefit transaction, with the entire amount of the payment treated as the excess benefit. Thus, the substantial contributor is subject to an initial tax of 25 percent of the amount of the payment under Code section 4958(a)(1) and an organization manager that participated in the making of the payment, knowing that the payment was a grant, loan, payment of compensation, or other similar payment to a substantial contributor, is subject to a tax of 10 percent of the amount of the payment under section Code 4958(a)(2). The second tier taxes and other rules of section 4958 also apply to such payments.

The provision applies to payments by a supporting organization to a substantial contributor but not to payments by a substantial contributor to a supporting organization.

A "substantial contributor" means any person (or a relative or controlled entity of any person) who contributed or bequeathed an aggregate amount of more than $5,000 to the organization, if the contributed amount is more than two percent of the total contributions and bequests received by the organization before the close of the taxable year of the organization in which the contribution or bequest is received by the organization from such person. In the case of a trust, a substantial contributor also includes the creator of the trust. A substantial contributor does not include a public charity (other than a supporting organization).

Loans by any supporting organization (Type I, Type II, or Type III) to a disqualified person (as defined in Code section 4958) of the supporting organization are also treated as an excess benefit

transaction and the entire amount of the loan is treated as an excess benefit. A disqualified person does not include a public charity (other than a supporting organization).

Excess Business Holdings of Supporting Organizations. H.R. 4 extends the excess business holdings rules applicable to private foundations to Type III supporting organizations (other than functionally integrated Type III supporting organizations). In applying these rules to Type III supporting organizations, the term "disqualified person" has the meaning provided in Code section 4958, and also includes substantial contributors and related persons and any organization that is effectively controlled by the same person or persons who control the supporting organization or any organization substantially all of the contributions to which were made by the same person or persons who made substantially all of the contributions to the supporting organization. The excess business holdings rules do not apply if, as of November 18, 2005, the holdings were held (and at all times thereafter, are held) for the benefit of the community pursuant to the direction (made as of such date) of a State attorney general or a State official with jurisdiction over the Type III supporting organization.

Treatment of Amounts Paid to Supporting Organizations by Private Foundations. The bill amends the private foundation provisions of the Code to prohibit a non-operating private foundation from counting as a qualifying distribution (under Code section 4942) any amount paid to (1) a Type III supporting organization that is not a functionally integrated Type III supporting organization or (2) any other supporting organization if a disqualified person with respect to the foundation 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.