TECHNICAL EXPLANATION OF THE TAX REFORM ACT OF 2014, A DISCUSSION DRAFT OF THE CHAIRMAN OF THE HOUSE COMMITTEE ON WAYS AND MEANS TO REFORM THE INTERNAL REVENUE CODE: TITLE V ─ TAX EXEMPT ENTITIES

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INTRODUCTION

This document[1] provides a technical explanation of Title V of the Tax Reform Act of 2014, a discussion draft[2] prepared by the Chairman of the House Committee on Ways and Means that proposes to reform the Internal Revenue Code. Title V of the proposal addresses tax reform of tax exempt entities.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Technical Explanation of the Tax Reform Act of 2014, A Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code: Title V ─ Tax Exempt Entities* (JCX-16-14), February 26, 2014. This document can also be found on our website at www.jct.gov.

[2] Statutory draft version Camp_041.XML.

TITLE V – TAX EXEMPT ENTITIES

A. Unrelated Business Income Tax

PRESENT LAW

Tax exemption for certain organizations

Section 501(a) exempts certain organizations from Federal income tax. Such organizations include: (1) tax-exempt organizations described in section 501(c) (including among others section 501(c)(3) charitable organizations and section 501(c)(4) social welfare organizations); (2) religious and apostolic organizations described in section 501(d); and (3) trusts forming part of a pension, profit-sharing, or stock bonus plan of an employer described in section 401(a).

Section 115 excludes from gross income certain income of entities that perform an essential government function. The exemption applies to: (1) income derived from any public utility or the exercise of any essential governmental function and accruing to a State or any political subdivision thereof, or the District of Columbia; or (2) income accruing to the government of any possession of the United States, or any political subdivision thereof.

Unrelated business income tax, in general

An exempt organization generally may have revenue from four sources: contributions, gifts, and grants; trade or business income that is related to exempt activities (*e.g.*, program service revenue); investment income; and trade or business income that is not related to exempt activities. The Federal income tax exemption generally extends to the first three categories, and does not extend to an organization's unrelated trade or business income. In some cases, however, the investment income of an organization is taxed as if it were unrelated trade or business income.[3]

The unrelated business income tax ("UBIT") generally applies to income derived from a trade or business regularly carried on by the organization that is not substantially related to the performance of the organization's tax-exempt functions.[4] An organization that is subject to UBIT and that has $1,000 or more of gross unrelated business taxable income must report that income on Form 990-T (Exempt Organization Business Income Tax Return).

Most exempt organizations may operate an unrelated trade or business so long as the organization remains primarily engaged in activities that further its exempt purposes. Therefore, an organization may engage in a substantial amount of unrelated business activity without jeopardizing exempt status. A section 501(c)(3) (charitable) organization, however, may not

[3] This is the case for social clubs (sec. 501(c)(7)), voluntary employees' beneficiary associations (sec. 501(c)(9)), and organizations and trusts described in sections 501(c)(17) and 501(c)(20). Sec. 512(a)(3).

[4] Secs. 511-514.

operate an unrelated trade or business as a substantial part of its activities.[5] Therefore, the unrelated trade or business activity of a section 501(c)(3) organization must be insubstantial.

Organizations subject to tax on unrelated business income

Most exempt organizations are subject to the tax on unrelated business income. Specifically, organizations subject to the unrelated business income tax generally include: (1) organizations exempt from tax under section 501(a), including organizations described in section 501(c) (except for U.S. instrumentalities and certain charitable trusts) ;[6] (2) qualified pension, profit-sharing, and stock bonus plans described in section 401(a);[7] and (3) certain State colleges and universities.[8]

Exclusions from Unrelated Business Taxable Income

In general

Certain types of income are specifically exempt from unrelated business taxable income, such as dividends, interest, royalties, and certain rents,[9] unless derived from debt-financed property or from certain 50-percent controlled subsidiaries.[10] Other exemptions from UBIT are provided for activities in which substantially all the work is performed by volunteers, for income from the sale of donated goods, and for certain activities carried on for the convenience of members, students, patients, officers, or employees of a charitable organization. In addition, special UBIT provisions exempt from tax activities of trade shows and State fairs, income from bingo games, and income from the distribution of low-cost items incidental to the solicitation of charitable contributions. Organizations liable for tax on unrelated business taxable income may be liable for alternative minimum tax determined after taking into account adjustments and tax preference items.

Research income

Certain income derived from research activities of exempt organizations is excluded from unrelated business taxable income. For example, income derived from research performed for the United States, a State, and certain agencies and subdivisions is excluded.[11] Income from

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[5] Treas. Reg. sec. 1.501(c)(3)-1(e).

[6] Sec. 511(a)(2)(A).

[7] Sec. 511(a)(2)(A).

[8] Sec. 511(a)(2)(B).

[9] Secs. 511-514.

[10] Sec. 512(b)(13).

[11] Sec. 512(b)(7).

research performed by a college, university or hospital for any person also is excluded.[12] Finally, if an organization is operated primarily for purposes of carrying on fundamental research the results of which are freely available to the general public, all income derived by research performed by such organization for any person, not just income derived from research available to the general public, is excluded.[13]

<u>Gain or loss from disposition of real property acquired from financial institutions in conservatorship or receivership</u>

Section 512(b)(16) provides an exclusion from unrelated business taxable income for income from sales of property held for sale in the ordinary course of a trade or business by excluding gains and losses from the sale, exchange, or other disposition of certain real property and mortgages acquired from financial institutions that are in conservatorship or receivership. The exclusion is limited to properties designated by the taxpayer within nine months of acquisition as property held for sale, except that not more than one-half of property acquired in a single transaction may be so designated. The disposition generally must occur within 30 months of the date of acquisition.

<u>Specific deduction against unrelated business taxable income</u>

In computing unrelated business taxable income, an exempt organization may take a specific deduction of $1,000. This specific deduction may not be used to create a net operating loss that will be carried back or forward to another year.[14]

In the case of a diocese, province or religious order, or a convention or association of churches, a specific deduction is allowed with respect to each parish, individual church, district, or other local unit. The specific deduction is equal to the lower of $1,000 or the gross income derived from any unrelated trade or business regularly carried on by the local unit.[15]

<u>Deduction against unrelated business taxable income for charitable contributions</u>

In computing unrelated business taxable income, an exempt organization may deduct certain charitable contributions made to other organizations (generally, contributions that satisfy the requirements of section 170), whether or not directly connected with the carrying on of the trade or business. For most organizations subject to that tax on unrelated business income – *i.e.*, those described in section 511(a) – the charitable contribution deduction is limited to 10 percent of the unrelated business taxable income, computed without regard to the deduction of charitable contributions.[16] A separate rule applies in determining the charitable contribution deduction for

[12] Sec. 512(b)(8).

[13] Sec. 512(b)(9).

[14] Sec. 512(b)(12).

[15] *Ibid*.

[16] Sec. 512(b)(10).

charitable trusts described in section 511(b).[17] For such trusts, the charitable contribution percentage limitations under section 170(b)(1)(A) and 170(b)(1)(B) generally apply in determining the trust's charitable contribution deduction, but with the percentage limits being determined with respect to the trust's unrelated business taxable income instead of its adjusted gross income.[18]

Qualified sponsorship payments

Under section 513(i), the activity of soliciting or receiving qualified sponsorship payments by a tax-exempt organization is not an unrelated trade or business. As a result, such payments are exempt from UBIT.

"Qualified sponsorship payments" are defined as any payment made by a person engaged in a trade or business with respect to which the person will receive no substantial return benefit other than the use or acknowledgment of the name or logo (or product lines) of the person's trade or business in connection with the organization's activities.[19] Such a use or acknowledgment does not include advertising of such person's products or services – meaning qualitative or comparative language, price information or other indications of savings or value, or an endorsement or other inducement to purchase, sell, or use such products or services.[20] Thus, for example, if, in return for receiving a sponsorship payment, an organization promises to use the sponsor's name or logo in acknowledging the sponsor's support for an educational or fundraising event conducted by the organization, such payment will not be subject to UBIT. In contrast, if the organization provides advertising of a sponsor's products, the payment made to the organization by the sponsor in order to receive such advertising will be subject to UBIT (provided that the other requirements for UBIT liability are satisfied).

The term "qualified sponsorship payment" does not include any payments where the amount of such payment is contingent, by contract or otherwise, upon the level of attendance at an event, broadcast ratings, or other factors indicating the degree of public exposure to an activity.[21] The term also excludes payments that entitle the payor to the use or acknowledgment of the payor's trade or business name or logo (or product lines) in tax-exempt organization periodicals.[22] Such payments are outside the qualified sponsorship payment provision's safe-harbor exclusion, and, therefore, are governed by generally applicable rules that determine whether the payment is subject to UBIT. Thus, for example, payments that entitle the payor to a

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[17] For purposes of the trust's charitable contribution deduction, a distribution by the trust is treated as a gift or contribution. Sec. 512(b)(11).

[18] Sec. 512(b)(11).

[19] Sec. 513(i)(2)(A).

[20] Sec. 513(i)(2)(A).

[21] Sec. 513(i)(2)(B)(i).

[22] Sec. 513(i)(2)(B)(ii).

depiction of the payor's name or logo in a tax-exempt organization periodical may or may not be subject to UBIT depending on the application of rules regarding periodical advertising and nontaxable donor recognition. For this purpose, the term "periodical" means regularly scheduled and printed material published by (or on behalf of) the payee organization that is not related to and primarily distributed in connection with a specific event conducted by the payee organization. In addition, the safe-harbor exclusion for qualified sponsorship payments does not apply to payments made in connection with "qualified convention or trade show activities," as defined in section 513(d)(3).[23]

To the extent that a portion of a payment would (if made as a separate payment) be a qualified sponsorship payment, such portion of the payment is treated as a separate payment.[24]

Operation of multiple unrelated trades or businesses

An organization determines its unrelated business taxable income by subtracting from its gross unrelated business income deductions directly connected with the unrelated trade or business.[25] Under regulations, in determining unrelated business taxable income, an organization that operates multiple unrelated trades or businesses aggregates income from all such activities and subtracts from the aggregate gross income the aggregate of deductions.[26] As a result, an organization may use a loss from one unrelated trade or business to offset gain from another, thereby reducing total unrelated business taxable income.

1. Clarification of unrelated business income tax treatment of entities exempt from tax under section 501(a) (sec. 5001 of the discussion draft and sec. 511 of the Code)

Description of Proposal

The proposal clarifies that an organization does not fail to be subject to tax on its unrelated business income as an organization exempt from tax under section 501(a) solely because the organization also is exempt, or excludes amounts from gross income, by reason of another provision of the Code. For example, if an organization is described in section 401(a) (and thus is exempt from tax under section 501(a)) and its income also is described in section 115 (relating to the exclusion from gross income of certain income derived from the exercise of an essential governmental function), its governmental status under section 115 does not cause it to be exempt from tax on its unrelated business income.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

[23] Sec. 513(i)(2)(B)(ii).

[24] Sec. 513(i)(3).

[25] Sec. 512(a).

[26] Treas. Reg. sec. 1.512(a)-1(a).

2. Name and logo royalties treated as unrelated business taxable income (sec. 5002 of the discussion draft and secs. 512 and 513 of the Code)

Description of Proposal

The proposal modifies the UBIT treatment of the licensing of an organization's name or logo generally to subject royalty income derived from such a license to UBIT. Specifically, the proposal amends section 513 (regarding unrelated trades or businesses) to provide that any sale or licensing by an organization of any name or logo of the organization (including any trademark or copyright related to a name or logo) is treated as an unrelated trade or business that is regularly carried on by the organization. In addition, the proposal amends section 512 (regarding unrelated business taxable income) to provide that income derived from any such licensing of a name or logo of the organization is included in the organization's gross unrelated business taxable income, notwithstanding the provisions of section 512 that otherwise exclude certain types of passive income (including royalties) from unrelated business taxable income.[27]

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

3. Unrelated business taxable income separately computed for each trade or business (sec. 5003 of the discussion draft and sec. 512 of the Code)

Description of Proposal

For an organization with more than one unrelated trade or business, the proposal requires that unrelated business taxable income first be computed separately with respect to each trade or business and without regard to the specific deduction generally allowed under section 512(b)(12). The organization's unrelated business taxable income for a taxable year is the sum of the amounts (not less than zero) computed for each separate unrelated trade or business, less the specific deduction allowed under section 512(b)(12). A net operating loss deduction is allowed only with respect to a trade or business from which the loss arose.

The result of the proposal is that a loss from one trade or business for a taxable year may not be used to offset gain from a different unrelated trade or business for the same taxable year. The proposal generally does not, however, prevent an organization from using a loss from one taxable year to offset gain from the same unrelated trade or business activity in another taxable year, where appropriate.

Effective Date

The proposal generally is effective for taxable years beginning after December 31, 2014.

[27] Specifically, the proposal references sections 512(b)(1), (2), (3) and (5).

Special transition rules apply for net operating loss carryforwards and carrybacks. In the case of a net operating loss arising in a taxable year beginning before January 1, 2015, and carried over to a year beginning on or after such date, the new rule that allows a net operating loss deduction only with respect to the trade or business from which the loss arose shall not apply. In the case of a net operating loss arising in a taxable year beginning after December 31, 2014, and carried back to a taxable year beginning on or before such date, the net operating loss deduction is allowed only with respect to the trade or business from which the loss arose.

4. Exclusion of research income from unrelated business taxable income limited to publicly available research (sec. 5004 of the discussion draft and sec. 512(b)(9) of the Code)

Description of Proposal

The proposal modifies the exclusion of income from research performed by an organization operated primarily for purposes of carrying on fundamental research the results of which are freely available to the general public (section 512(b)(9)). Under the proposal, the organization may exclude from unrelated business taxable income under section 512(b)(9) only income from such fundamental research the results of which are freely available to the general public.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

5. Parity of charitable contribution limitation between trusts and corporations for purposes of computing unrelated business taxable income (sec. 5005 of the discussion draft and sec. 512(b)(11) of the Code)

Description of Proposal

The proposal modifies the charitable deduction percentage limit that applies under section 512(b)(11) in determining the charitable contribution deduction a charitable trust described in section 511(b) may take in computing its unrelated business taxable income to align with the limit that applies to a corporation. Under the proposal, the trust's charitable contribution deduction is limited to 10 percent of its unrelated business taxable income computed without regard to the deduction for charitable contributions. The percentage limits of sections 170(b)(1)(A) and 170(b)(1)(B) no longer apply.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

6. Increase in specific deduction against unrelated business taxable income (sec. 5006 of the discussion draft and sec. 512(b)(12) of the Code)

Description of Proposal

The proposal increases the specific deduction described in section 512(b)(12) from $1,000 to $10,000 (or, in the case of a diocese, province or religious order, or a convention or association of churches, the lower of $10,000 or the gross income derived from any unrelated trade or business regularly carried on by each parish, individual church, district or other local unit).

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

7. Repeal of exclusion from unrelated business taxable income of gain or loss from the disposition of distressed property (sec. 5007 of the discussion draft and sec. 512(b)(16) of the Code)

Description of Proposal

The proposal repeals the exclusion from unrelated business taxable income of gain or loss from the disposition of real property acquired from financial institutions in conservatorship or receivership (section 512(b)(16)).

Effective Date

The proposal is effective for property acquired after December 31, 2014.

8. Modify rules concerning qualified sponsorship payments (sec. 5008 of the discussion draft and sec. 513(i) of the Code)

Description of Proposal

The proposal modifies the definition of "qualified sponsorship payment" to exclude from the permitted substantial return benefit the use or acknowledgment of the sponsor's product lines. In other words, if in exchange for a payment from a sponsor the exempt organization uses or acknowledges the sponsor's product lines, the payment is not a qualified sponsorship payment. The proposal makes a conforming change (regarding the use or acknowledgment of product lines) to the exclusion from the qualified sponsorship payment safe-harbor for periodicals.

The proposal includes a special rule for an event with respect to which an organization receives an aggregate amount of sponsorship payments greater than $25,000. A payment with respect to such an event is not a qualified sponsorship payment unless any use or acknowledgment of the sponsor's name or logo only appears with, and in substantially the same manner as, the names of a significant portion of the other donors to the organization with respect to such event. A significant portion of the donors to the organization with respect to an event is determined by taking into account both the total number of donors to the event and the amounts contributed to the event by such donors, but in no event shall fewer than two other donors be treated as a significant portion of other donors.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

B. Penalties

1. Increase in information return penalties (sec. 5101 of the discussion draft and sec. 6652(c) of the Code)

Present Law

In general

The Code imposes penalties in the event an exempt organization fails to make certain required disclosures or file required information returns.[28] The penalties are not imposed if it is shown that a failure was due to reasonable cause.[29] In certain situations, a penalty may also be imposed against certain persons who fail to make such a filing. Solely for this purpose, the term "person" means an officer, director, trustee, employee, or other individual who is under a duty to perform the act in respect to which the failure occurs.[30]

Failure to file an exempt organization or political organization annual information return (secs. 6652(c)(1)(A) and (B))

In the event of a failure by an exempt organization or political organization to file a return required under section 6033(a)(1) or 6012(a)(6), respectively, or a failure to include any of the information required to be shown on such a return or to show the correct information, section 6652(c)(1)(A) imposes a penalty on the exempt organization of $20 for each day during which the failure continues. The maximum penalty with respect to any one return is limited to the lesser of $10,000 or five percent of the gross receipts of the organization for the year. For organizations with gross receipts exceeding $1 million for the year, the daily penalty amount is increased from $20 to $100, and the maximum penalty is $50,000.

In the event an organization is subject to a penalty under section 6652(c)(1)(A) (described in the preceding paragraph), the Secretary may make a written demand on the organization specifying a reasonable future date by which the return shall be filed or the information furnished. If any person fails to comply with such a demand on or before the date specified in the demand, section 6652(c)(1)(B) imposes a penalty of $10 for each day after the expiration of the time specified in the demand during which the failure continues. The maximum penalty that may be imposed on all persons with respect to any one return is limited to $5,000.

Failure to make annual returns available for public inspection (sec. 6652(c)(1)(C))

Section 6104(d) generally requires certain organizations exempt from tax to make available for public inspection their three most recent annual information returns (Forms 990) and application for tax exemption. Section 527(j) requires certain political organizations to make

[28] Sec. 6652.

[29] Sec. 6652(c)(4).

[30] Sec. 6652(c)(5)(C).

disclosures of expenditures and contributions. In the event of a failure to comply with section 6104(d) with respect to an annual information return or the disclosure requirements of section 527(j), section 6652(c)(1)(C) imposes on any person failing to meet the requirements a penalty of $20 for each day during which the failure continues. The maximum penalty on all persons for failures with respect to any one return or report is limited to $10,000.

Failure to make application for exemption or notice of status available for public inspection (sec. 6652(c)(1)(D))

In the event of a failure to comply with 6104(d) with respect to any exempt status application materials or notice materials (as defined in section 6104(d)), section 6652(c)(1)(D) imposes on any person failing to meet the requirements a penalty of $20 for each day during which the failure continues.

Charitable trust returns; exempt organizations liquidating, dissolving, or terminating (sec. 6652(c)(2))

In the case of a failure to file a return required under section 6034(b) (relating to certain trusts other than split-interest trusts) or 6043(b) (relating to terminations, etc. of exempt organizations), section 6652(c)(2)(A) imposes a penalty on the organization or trust failing to file equal to $10 per day for each day during which the failure continues (up to a maximum of $5,000 per return).

In the event a penalty is imposed on the organization or trust under section 6652(c)(2)(A), the Secretary may make a written demand on the organization or trust specifying a reasonable future date by which a filing shall be made. If any person fails to comply with such a demand on or before the date specified in the demand, section 6652(c)(2)(B) imposes a penalty of $10 for each day after the expiration of the time specified in the demand during with the failure continues. The maximum penalty that may be imposed on all persons with respect to any one return is limited to $5,000.

In the case of a failure to file a return under section 6034(a) by a charitable split-interest trust, section 6652(c)(2)(C) provides that the penalties generally applicable to the failure to file an exempt organization return (under section 6652(c)(2)(A)) will apply, except that, in general (1) the five-percent limitation shall not apply, and (2) the increase in the penalty from $20 to $100 (and the maximum penalty from $10,000 to $50,000) shall apply to trusts with gross income in excess of $250,000. In addition to any penalty on the trust, if the person required to file the return knowingly fails to file it, the above penalty also is imposed on the person, who is personally liable for the penalty.

Failure to file a reportable transaction disclosure (sec. 6652(c)(3))

Section 6033(a)(2) generally requires an exempt organization to file a disclosure if it is a party to any prohibited tax shelter transaction within the meaning of section 4965(e). In the case of a failure to file such a disclosure, section 6652(c)(3)(A) imposes a penalty on the organization (or, in some cases, on an entity manager) of $100 for each day during which the failure continues (up to a maximum of $50,000 per return).

In the event a penalty is imposed under section 6652(c)(3)(A), the Secretary may make a written demand on an entity or manager specifying a reasonable future date by which a filing shall be made. If any entity or manager fails to comply with such a demand on or before the date specified in the demand, section 6652(c)(3)(B) imposes a penalty of $100 for each day after the expiration of the time specified in the demand during with the failure continues. The maximum penalty that may be imposed on all entities and managers with respect to any one disclosure is limited to $10,000.

Description of Proposal

As described below, the proposal doubles each of the daily penalty amounts described above.

Failure to file an exempt organization or political organization annual information return (secs. 6652(c)(1)(A) and (B))

The proposal increases the daily penalties under section 6652(c)(1)(A) from $20 to $40 and from $100 to $200. The daily penalty on managers under section 6652(c)(1)(B) is increased from $10 to $20.

Failure to make annual returns available for public inspection (sec. 6652(c)(1)(C))

The proposal increases the daily penalty under section 6652(c)(1)(C) from $20 to $40.

Failure to make application for exemption or notice of status available for public inspection (sec. 6652(c)(1)(D))

The proposal increases the daily penalty under section 6652(c)(1)(D) from $20 to $40.

Charitable trust returns; exempt organizations liquidating, dissolving, or terminating (sec. 6652(c)(2))

The proposal increases the daily penalties under sections 6652(c)(2)(A), (B), and (C)(ii) from $10 to $20 and from $100 to $200.

Failure to file a reportable transaction disclosure (sec. 6652(c)(3))

The proposal increases the daily penalties under sections 6652(c)(3)(A) and (B) from $100 to $200.

Effective Date

The proposal is effective for information returns required to be filed on or after January 1, 2015.

2. Manager-level accuracy-related penalty on underpayment of unrelated business income tax (sec. 5102 of the discussion draft and secs. 6662 and 6662A of the Code)

Present Law

General accuracy-related penalty (sec. 6662)

An accuracy-related penalty under section 6662 applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 (or, in the case of corporations, by the lesser of (a) 10 percent of the correct tax (or $10,000 if greater) or (b) $10 million), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.[31] Except in the case of tax shelters,[32] the amount of any understatement is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment. The Secretary may prescribe a list of positions that the Secretary believes do not meet the requirements for substantial authority under this provision.

The section 6662 penalty generally is abated (even with respect to tax shelters) in cases in which the taxpayer can demonstrate that there was "reasonable cause" for the underpayment and that the taxpayer acted in good faith.[33] The relevant regulations provide that reasonable cause exists where the taxpayer "reasonably relies in good faith on [a professional] tax advisor's analysis of the pertinent facts and authorities [that] . . . unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged" by the IRS.[34]

With certain exceptions, section 6662 does not apply to any portion of an underpayment that is attributable to a reportable transaction understatement on which a penalty is imposed under section 6662A (discussed below).[35]

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[31] Sec. 6662.

[32] A tax shelter is defined for this purpose as a partnership or other entity, an investment plan or arrangement, or any other plan or arrangement if a significant purpose of such partnership, other entity, plan, or arrangement is the avoidance or evasion of Federal income tax. Sec. 6662(d)(2)(C).

[33] Sec. 6664(c).

[34] Treas. Reg. sec. 1.6662-4(g)(4)(i)(B). See also Treas. Reg. sec. 1.6664-4(c).

[35] Sec. 6662(b) (flush language).

Accuracy-related penalty on understatements with respect to reportable transactions (sec. 6662A)

A separate accuracy-related penalty under section 6662A applies to "listed transactions" and to other "reportable transactions" with a significant tax avoidance purpose. The penalty rate and defenses available to avoid the penalty vary depending on whether the transaction was adequately disclosed.

Regulations under section 6011 require a taxpayer to disclose with its tax return certain information with respect to each "reportable transaction" in which the taxpayer participates.[36] A reportable transaction is defined as one that the Secretary determines is required to be disclosed because it is determined to have a potential for tax avoidance or evasion.[37] There are five categories of reportable transactions: listed transactions, confidential transactions, transactions with contractual protection, certain loss transactions and transactions of interest.[38] Transactions falling under the first and last categories of reportable transactions are transactions that are described in publications issued by the Treasury Department and identified as one of these types of transaction. A listed transaction is defined as a reportable transaction that is the same as, or substantially similar[39] to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of the reporting disclosure requirements.[40]

Description of Proposal

In the case of a substantial understatement of income tax under section 6662 that is attributable to the unrelated business income tax of an organization imposed under section 511, the proposal imposes a new penalty on any manager of such organization. The tax equals five percent of the underpayment attributable to such understatement. For this purpose, the term "manager" includes any officer, director, trustee, employee, or other individual who is under a duty to perform an act in respect of which the underpayment occurs. If more than one person is liable for the manager-level penalty with respect to an understatement, all such persons are jointly and severally liable with respect to such understatement. The maximum amount of manager-level penalty that may be imposed with respect to an understatement is $20,000.

In the case of any portion of a reportable understatement of unrelated business income tax of an organization imposed under section 511 to which the accuracy-related penalty under

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[36] Treas. Reg. sec. 1.6011-4.

[37] Sec. 6707A(c)(1).

[38] Treas. Reg. sec. 1.6011-4(b)(2)-(6).

[39] The regulations clarify that the term "substantially similar" includes any transaction that is expected to obtain the same or similar types of tax consequences and that is either factually similar or based on the same or similar tax strategy. Further, the term must be broadly construed in favor of disclosure. Treas. Reg. sec. 1.6011-4(c)(4).

[40] Sec. 6707A(c)(2).

section 6662A (relating to reportable transactions) applies, the proposal imposes a new penalty on any manager of such organization. The penalty equals 10 percent of the portion of the underpayment to which the reportable transaction understatement relates. For this purpose, the term "manager" includes any officer, director, trustee, employee, or other individual who is under a duty to perform an act in respect of which the underpayment occurs. If more than one person is liable for the manager-level penalty with respect to a reportable transaction understatement, all such persons are jointly and severally liable with respect to such understatement. The maximum amount of manager-level penalty that may be imposed with respect to a reportable transaction understatement is $40,000.

The proposal includes a conforming change regarding the coordination of penalties under sections 6662 and 6662A (*i.e.*, the rule under which section 6662 generally does not apply to any portion of an underpayment which is attributable to a reportable transaction understatement on which a penalty is imposed under present law). The conforming change is intended to clarify that this coordination rule of present law also applies to the new manager penalties added by the proposal.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

C. Excise Taxes

1. Modification of taxes on excess benefit transactions (intermediate sanctions) (sec. 5201 of the discussion draft and sec. 4958 of the Code)

Present Law

Excess benefit transactions ("intermediate sanctions")

The Code imposes excise taxes on excess benefit transactions between disqualified persons and charitable organizations (other than private foundations) or social welfare organizations (as described in section 501(c)(4)).[41] The excess benefit transaction tax commonly is referred to as "intermediate sanctions."[42] An excess benefit transaction generally is a transaction in which an economic benefit is provided, directly or indirectly, by a charitable or social welfare organization to or for the use of a disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit. The excise tax is imposed on any such excess.

Disqualified persons

Disqualified persons generally include: (1) persons who were, at any time during the five-year period ending on the date of the transaction, in a position to exercise substantial influence over the affairs of the organization (including officers and directors); (2) a member of the family of such a person; and (3) certain 35-percent or more controlled entities.[43]

Special rules apply with respect to charities that are sponsoring organizations of donor advised funds. For such organizations, the term "disqualified person" also includes: (1) donors and certain other persons appointed by a donor to provide advice with respect to the fund (donor advisors); (2) investment advisors; and (3) members of the family and certain 35-percent or more controlled entities of a person described in (1) or (2).[44] An investment advisor is a person (other than an employee of the sponsoring organization) compensated by the organization for managing the investment of, or providing investment advice with respect to, assets maintained in donor advised funds owned by the organization.[45]

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[41] Sec. 4958.

[42] The excess benefit transaction rules were enacted in 1996 to provide a sanction short of revocation of tax exemption, an "intermediate" sanction, for abusive self-dealing transactions (*i.e.*, private inurement) between an organization insider and the organization. Prior to enactment of the excess benefit transaction rules, there was no sanction in the Code on organization insiders or disqualified persons for engaging in self-dealing transactions with respect to a public charity.

[43] Sec. 4958(f)(1).

[44] Secs. 4958(f)(1)(E) and (F).

[45] Sec. 4958(f)(8).

Rebuttable presumption of reasonableness

Under the intermediate sanctions regulations, in certain cases an exempt organization may avail itself of a rebuttable presumption with respect to compensation arrangements and property transfers. Payments under a compensation arrangement are presumed to be reasonable, and a transfer of property, or the right to use property, is presumed to be at fair market value, if: (1) the arrangement or terms of transfer are approved in advance by an authorized body of the organization (as defined below) composed entirely of individuals who do not have a conflict of interest with respect to the arrangement or transfer; (2) the authorized body obtained and relied upon appropriate data as to comparability prior to making its determination; and (3) the authorized body adequately documented the basis for its determination concurrently with making that determination.[46] If these requirements are satisfied, the IRS may overcome the presumption of reasonableness if it develops sufficient contrary evidence to rebut the probative value of the comparability data relied upon by the authorized body.[47]

An authorized body is defined as: (1) the governing body of the organization; (2) a committee of the governing body, which may be composed of any individuals permitted under State law to serve on such a committee, to the extent that the committee is permitted by State law to act on behalf of the governing body; or (3) to the extent permitted by State law, other parties authorized by the governing body of the organization to act on its behalf by following procedures specified by the governing body in approving compensation arrangements or property transfers.[48]

In general, an authorized body has appropriate data as to comparability if, given the knowledge and expertise of its members, it has information sufficient to determine whether the arrangement is reasonable in its entirety or the transfer is at fair market value.[49] In the case of compensation, relevant information includes, but is not limited to, compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; the availability of similar services in the geographic area of the applicable tax-exempt organization; current compensation surveys compiled by independent firms; and actual written offers from similar institutions competing for the services of the disqualified person. In the case of property, relevant information includes, but is not limited to, current independent appraisals of the value of all property to be transferred, and offers received as part of an open and competitive bidding process. For organizations with annual gross receipts (including contributions) of less than $1 million, the authorized body is considered to have appropriate data as to comparability if it has data on compensation paid by three comparable organizations in the same or similar communities for similar services. There is no inference with respect to whether circumstances

[46] Treas. Reg. sec. 53.4958-6(a). See also H. Rep. No. 506, 104th Congress, 2d Sess. 1996, pp. 53, 56-7.

[47] Treas. Reg. sec. 53.4958-6(b).

[48] Treas. Reg. sec. 53.4958-6(c)(1)(i).

[49] Treas. Reg. sec. 53.4958-6(c)(2)(i).

falling outside this safe harbor will meet the requirement with respect to the collection of appropriate data.[50]

In general, for a decision to be documented adequately, the written or electronic records of the authorized body must note: (1) the terms of the transaction that was approved and the date it was approved; (2) the members of the authorized body who were present during debate on the transaction that was approved and those who voted on it; (3) the comparability data obtained and relied upon by the authorized body and how the data was obtained; and (4) any actions taken with respect to consideration of the transaction by anyone who is otherwise a member of the authorized body but who had a conflict of interest with respect to the transaction.[51]

Amount of the excise tax

The excess benefit tax is imposed on the disqualified person and, in certain cases, on the organization's managers, but is not imposed on the exempt organization.

An initial tax of 25 percent of the excess benefit amount is imposed on the disqualified person that receives the excess benefit. An additional tax on the disqualified person of 200 percent of the excess benefit applies if the violation is not corrected. A tax of 10 percent of the excess benefit (not to exceed $20,000 with respect to any excess benefit transaction) is imposed on an organization manager who knowingly participated in the excess benefit transaction, if the manager's participation was willful and not due to reasonable cause, and if the initial tax was imposed on the disqualified person.[52] If more than one person is liable for the tax on disqualified persons or on management, all such persons are jointly and severally liable for the tax.[53]

Standard for knowing violations

A manager participates in a transaction knowingly only if the manager: (1) has actual knowledge of sufficient facts indicating that, based solely upon those facts, such transaction would be an excess benefit transaction; (2) is aware that such a transaction under these circumstances may violate the provisions of Federal tax law governing excess benefit transactions; and (3) negligently fails to make reasonable attempts to ascertain whether the transaction is an excess benefit transaction, or the manager is in fact aware that it is such a transaction.[54] The burden of proof in a Tax Court proceeding as to whether an organization manager (or foundation manager) acted knowingly is on the Secretary.[55]

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[50] Treas. Reg. sec. 53.4958-6(c)(2)(ii).

[51] Treas. Reg. sec. 53.4958-6(c)(3).

[52] Sec. 4958(d)(2). Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

[53] Sec. 4958(d)(1).

[54] Treas. Reg. sec. 53.4958-1(d)(4)(i).

[55] Sec. 7454(b).

Knowing does not mean having a reason to know.[56] However, evidence tending to show that an organization manager has reason to know of a particular fact or particular rule is relevant in determining whether the manager had actual knowledge of such a fact or rule. Thus, for example, evidence tending to show that a manager has reason to know of sufficient facts indicating that, based solely upon such facts, a transaction would be an excess benefit transaction is relevant in determining whether the manager has actual knowledge of such facts.[57]

Participation by an organization manager is willful if it is voluntary, conscious, and intentional. No motive to avoid the restrictions of the law or the incurrence of any tax is necessary to make the participation willful. Participation by an organization manager is not willful if the manager does not know that the transaction in which the manager is participating is an excess benefit transaction.[58] An organization manager's participation is due to reasonable cause if the manager has exercised responsibility on behalf of the organization with ordinary business care and prudence.[59]

Special rules

An organization manager's reliance on professional advice generally means that the manager has not knowingly participated in an excess benefit transaction. Under Treasury regulations, an organization manager's participation in a transaction ordinarily is not considered knowing, even though the transaction subsequently is held to be an excess benefit transaction, to the extent that, after full disclosure of the factual situation to an appropriate professional, the organization manager relies on a reasoned written opinion of that professional with respect to elements of the transaction within the professional's expertise. A written opinion is considered as reasoned even though it reaches a conclusion that is subsequently determined to be incorrect so long as the opinion addresses itself to the facts and the applicable standards. A written opinion is not considered to be reasoned if it does nothing more than recite the facts and express a conclusion. The absence of a written opinion of an appropriate professional with respect to a transaction does not, by itself, give rise to any inference that an organization manager participated in the transaction knowingly.

Appropriate professionals on whose written opinion an organization manager may rely, are: (1) legal counsel, including in-house counsel; (2) certified public accountants or accounting firms with expertise regarding the relevant tax law matters; and (3) independent valuation experts who hold themselves out to the public as appraisers or compensation consultants, perform the relevant valuations on a regular basis, are qualified to make valuations of the type of

[56] Treas. Reg. sec. 53.4958-1(d)(4)(ii).

[57] *Ibid.*

[58] Treas. Reg. sec. 53.4958-1(d)(5).

[59] Treas. Reg. sec. 53.4958-1(d)(6).

property or services involved, and include in the written opinion a certification that the three preceding requirements are met.[60]

An organization manager's participation in a transaction ordinarily is not considered knowing even though the transaction subsequently is held to be an excess benefit transaction, if an appropriate authorized body that approved the transaction meets the requirements of the rebuttable presumption of reasonableness with respect to the transaction.[61]

Description of Proposal

Entity-level tax in the event of an excess benefit transaction

Under the proposal, if an initial tax is imposed on a disqualified person under the intermediate sanctions rules,[62] the organization is subject to an excise tax equal to 10 percent of the excess benefit. No tax on the organization is imposed if the organization: (1) establishes that the minimum standards of due diligence (described below) were met with respect to the transaction; or (2) establishes to the satisfaction of the Secretary that other reasonable procedures were used to ensure that no excess benefit was provided.

Eliminate rebuttable presumption and establish due diligence procedures

The proposal eliminates the rebuttable presumption of reasonableness contained in the intermediate sanctions regulations. Under the proposal, the procedures that presently provide an organization with a presumption of reasonableness (*i.e.*, advance approval by an authorized body, reliance upon data as to comparability, and adequate and concurrent documentation) generally will establish instead that an organization has performed the minimum standards of due diligence with respect to an arrangement or transfer involving a disqualified person. Satisfaction of these minimum standards will not result in a presumption of reasonableness with respect to the transaction.

Eliminate certain special rules for knowing behavior by organization managers

The proposal eliminates the special rule that provides that an organization manager's participation ordinarily is not "knowing" for purposes of the intermediate sanctions excise taxes if the manager relied on professional advice. Although the proposal eliminates the special rule, whether an organization manager relies on professional advice is a relevant consideration in determining the manager knowingly participated in an excess benefit transaction.

The proposal also eliminates the special regulatory rule that provides that an organization manager ordinarily does not act knowingly for purposes of the excess benefit transaction excise tax if the organization has met the requirements of the rebuttable presumption procedure.

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[60] Treas. Reg. sec. 53.4958-1(d)(4)(iii).

[61] Treas. Reg. sec. 53.4958-1(d)(4)(iv).

[62] Sec. 4958(a)(1).

Treat investment advisors and athletic coaches as disqualified persons

The proposal modifies the definition of a disqualified person for purposes of the intermediate sanctions rules. First, a person who performs services as an athletic coach for the organization is treated as a disqualified person with respect to the organization. Second, the proposal (1) expands to all organizations that are subject to the intermediate sanctions rules the present-law rule that treats investment advisors to donor advised funds as disqualified persons, and (2) modifies the definition of investment advisor for this purpose. For all applicable tax-exempt organizations (including sponsoring organizations of donor advised funds), the term investment advisor means, with respect to an organization, any person compensated by the organization, and who is primarily responsible, for managing the investment of, or providing investment advice with respect to, assets of the organization.[63] For a sponsoring organization of a donor advised fund, the term investment advisor also includes any person who is an investment advisor with respect to a sponsoring organization under present law, *i.e.*, a person (other than an employee of the organization) compensated by such organization for managing the investment of, or providing investment advice with respect to, assets maintained in donor advised funds owned by the sponsoring organization.

Application of intermediate sanctions rules to section 501(c)(5) and section 501(c)(6) organizations

The proposal extends application of the section 4958 intermediate sanctions rules to tax-exempt organizations described in sections 501(c)(5) (labor and certain other organizations) and 501(c)(6) (business leagues and certain other organizations).

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

2. Modification of taxes on self-dealing (sec. 5202 of the discussion draft and sec. 4941 of the Code)

Present Law

Self-dealing involving private foundations, in general

Excise taxes are imposed on acts of self-dealing between a disqualified person (as defined in section 4946) and a private foundation.[64] In general, self-dealing transactions are any

[63] Under the proposal, the existing rules that treat as disqualified persons certain family members and 35-percent controlled entities of investment advisors to sponsoring organizations of donor advised funds will apply more broadly to investment advisors that are disqualified persons with respect to any organization subject to the intermediate sanctions rules.

[64] Sec. 4941. In general, a private foundation is a section 501(c)(3) organization (generally, a charitable organization) that does not meet the requirements of section 509(a) for being treated more favorably as a public charity.

direct or indirect: (1) sale or exchange, or leasing, of property between a private foundation and a disqualified person, including transfers of property subject to a mortgage or lien that the private foundation assumes or that was put on the property by the disqualified person within 10 years of the transfer; (2) lending of money or other extension of credit between a private foundation and a disqualified person, except for no-interest loans by a disqualified person, the proceeds of which are used exclusively for charitable purposes; (3) the furnishing of goods, services, or facilities between a private foundation and a disqualified person, unless the goods, services, or facilities are (i) functionally related to the foundation's exempt purposes and are provided to or by the foundation on the same basis as provided by the foundation or disqualified person to the general public, (ii) reasonable and necessary to performing exempt purposes and not excessive, or (iii) provided by disqualified person without charge; (4) the transfer to, or use by or for the benefit of, a disqualified person of the income or assets of the private foundation, unless the use or benefit is de minimis; and (5) certain payments of money or property to a government official. Leases provided by a disqualified person without charge to a private foundation, even if the foundation pays for maintenance, are permitted.

An initial tax of 10 percent of the amount involved with respect to an act of self-dealing is imposed on any disqualified person (other than a foundation manager acting only as such) who participates in the act of self-dealing. If such a tax is imposed, a five-percent tax of the amount involved is imposed on a foundation manager who participated in the act of self-dealing knowing it was such an act (and such participation was not willful and was due to reasonable cause) up to $20,000 per act. Such initial taxes may not be abated.[65] Such initial taxes are imposed for each year in the taxable period, which begins on the date the act of self-dealing occurs and ends on the earliest of the date of mailing of a notice of deficiency for the tax, the date on which the tax is assessed, or the date on which correction of the act of self-dealing is completed. A government official (as defined in section 4946(c)) is subject to such initial tax only if the official participates in the act of self-dealing knowing it is such an act. If the act of self-dealing is not corrected, a tax of 200 percent of the amount involved is imposed on the disqualified person and a tax of 50 percent of the amount involved (up to $20,000 per act) is imposed on a foundation manager who refused to agree to correcting the act of self-dealing. Such additional taxes are subject to abatement.[66]

Standard for knowing violations

A foundation manager participates in a transaction knowingly only if the manager: (1) has actual knowledge of sufficient facts indicating that, based solely upon those facts, such transaction would be an act of self-dealing; (2) is aware that such an act under these circumstances may violate the provisions of Federal tax law governing self-dealing; and (3) negligently fails to make reasonable attempts to ascertain whether the transaction is an act of

[65] Sec. 4962(b).

[66] Sec. 4961.

self-dealing, or the manager is in fact aware that it is such an act.[67] The burden of proof in a Tax Court proceeding as to whether a foundation manager acted knowingly is on the Secretary.[68]

Knowing does not mean having a reason to know.[69] However, evidence tending to show that a person has reason to know of a particular fact or rule is relevant in determining whether he had actual knowledge of such a fact or rule. Thus, for example, evidence tending to show that a person has reason to know of sufficient facts indicating that, based solely upon such facts, a transaction would be an act of self-dealing is relevant in determining whether the person has actual knowledge of such facts.[70]

Participation by a foundation manager is willful if it is voluntary, conscious, and intentional. No motive to avoid the restrictions of the law or the incurrence of any tax is necessary to make the participation willful. Participation by a foundation manager is not willful if the manager does not know that the transaction in which the manager is participating is an act of self-dealing.[71] A foundation manager's participation is due to reasonable cause if the manager has exercised responsibility on behalf of the organization with ordinary business care and prudence.[72]

Special rules

A foundation manager's reliance on advice of legal counsel generally means that the manager has not knowingly participated in an act of self-dealing. Under Treasury regulations, a foundation manager's participation in a transaction ordinarily is not considered knowing, even though the transaction subsequently is held to be an act of self-dealing, to the extent that, after full disclosure of the factual situation to legal counsel (including in-house counsel), the manager relies on a reasoned written legal opinion that an act is not an act of self-dealing. A written opinion is considered as reasoned even though it reaches a conclusion that is subsequently determined to be incorrect so long as the opinion addresses itself to the facts and the applicable law. A written opinion is not considered to be reasoned if it does nothing more than recite the facts and express a conclusion. The absence of advice of counsel with respect to a transaction does not, by itself, give rise to any inference that a foundation manager participated in the transaction knowingly.[73]

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[67] Treas. Reg. sec. 53.4941(a)-1(b)(3).

[68] Sec. 7454(b).

[69] Treas. Reg. sec. 53.4941(a)-1(b)(3).

[70] *Ibid.*

[71] Treas. Reg. sec. 53.4941(a)-1(b)(4).

[72] Treas. Reg. sec. 53.4941(a)-1(b)(5).

[73] Treas. Reg. sec. 53.4941(a)-1(b)(6).

Description of Proposal

Entity level tax on private foundations

Under the proposal, if an initial tax is imposed on a disqualified person under the self-dealing rules[74] the organization is subject to an excise tax equal to 2.5 percent (10 percent in the case of a payment of compensation) of the amount involved with respect to the act of self-dealing for each year (or part thereof) in the taxable period.

Eliminate special rule for knowing behavior by foundation managers

The proposal eliminates the special rule that provides that a foundation manager's participation ordinarily is not "knowing" for purposes of the self-dealing excise taxes if the manager relied on advice of counsel. Although the proposal eliminates the special rule, whether a foundation manager relies on advice of counsel is a relevant consideration in determining whether the manager knowingly participated in an act of self-dealing.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

3. Excise tax on failure to distribute within five years a contribution to a donor advised fund (sec. 5203 of the discussion draft and new sec. 4968 of the Code)

Present Law

Overview

Some charitable organizations (including community foundations) establish accounts to which donors may contribute and thereafter provide nonbinding advice or recommendations with regard to distributions from the fund or the investment of assets in the fund. Such accounts are commonly referred to as "donor advised funds." Donors who make contributions to charities for maintenance in a donor advised fund generally claim a charitable contribution deduction at the time of the contribution.[75] Although sponsoring charities frequently permit donors (or other

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[74] Sec. 4941(a)(1).

[75] Contributions to a sponsoring organization for maintenance in a donor advised fund are not eligible for a charitable deduction for income tax purposes if the sponsoring organization is a veterans' organization described in section 170(c)(3), a fraternal society described in section 170(c)(4), or a cemetery company described in section 170(c)(5); for gift tax purposes if the sponsoring organization is a fraternal society described in section 2522(a)(3) or a veterans' organization described in section 2522(a)(4); or for estate tax purposes if the sponsoring organization is a fraternal society described in section 2055(a)(3) or a veterans' organization described in section 2055(a)(4). 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 (other than a functionally integrated Type III supporting organization). In addition to satisfying generally applicable substantiation requirements under section 170(f), a donor must obtain, with respect to each charitable contribution to a sponsoring organization to be maintained in a donor advised fund, a contemporaneous

persons appointed by donors) to provide nonbinding recommendations concerning the distribution or investment of assets in a donor advised fund, sponsoring charities generally must have legal ownership and control of such assets following the contribution. If the sponsoring charity does not have such control (or permits a donor to exercise control over amounts contributed), the donor's contributions may not qualify for a charitable deduction, and, in the case of a community foundation, the contribution may be treated as being subject to a material restriction or condition by the donor.

Statutory definition of a donor advised fund

The Code 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 in order for a fund or account to be treated as a donor advised fund.[76]

A "sponsoring organization" is an organization that: (1) is described in section 170(c)[77] (other than a governmental entity described in section 170(c)(1), and without regard to any requirement that the organization be organized in the United States[78]); (2) is not a private foundation (as defined in section 509(a)); and (3) maintains one or more donor advised funds.[79]

Excess business holdings

The excess business holdings rules of section 4943 are applied to donor advised funds.[80] In applying such rules, the term disqualified person means, with respect to a donor advised fund,

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

76 See sec. 4966(d)(2)(A). A donor advised fund does not include a fund or account that makes distributions only to a single identified organization or governmental entity. A donor advised fund also does not include certain funds or accounts with respect to which a donor or donor advisor provides advice as to which individuals receive grants for travel, study, or other similar purposes. In addition, the Secretary may exempt a fund or account from treatment as a donor advised fund if such fund or account is advised by a committee not directly or indirectly controlled by a donor, donor advisor, or persons related to a donor or donor advisor. The Secretary also may exempt a fund or account from treatment as a donor advised fund if such fund or account benefits a single identified charitable purpose. Secs. 4966(d)(2)(B) and (C).

77 Section 170(c) describes organizations to which charitable contributions that are deductible for income tax purposes can be made.

78 See sec. 170(c)(2)(A).

79 Sec. 4966(d)(1).

80 Sec. 4943(e).

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.[81]

Excess benefit transactions, taxable distributions, and more than incidental benefit

Excess benefit transactions

Under section 4958, an excise tax is imposed in the event of an excess benefit transaction between a disqualified person (generally, an organization insider) and an applicable tax-exempt organization. An excess benefit transaction generally is a transaction in which an economic benefit is provided by an organization to or for the use of a disqualified person if the value of the economic benefit provided exceeds the value of consideration received in exchange for the benefit.[82] Applicable tax-exempt organizations include section 501(c)(3) public charities and organizations described in section 501(c)(4) (generally, social welfare organizations) or 501(c)(29) (qualified nonprofit health insurance issuers).[83]

Section 4958 includes special excess benefit transaction rules for donor advised funds. Any grant, loan, compensation, or other similar payment from a donor advised fund to a person that with respect to such fund is a donor, donor advisor, or a person related[84] to a donor or donor advisor automatically is treated as an excess benefit transaction under section 4958, with the entire amount paid to any such person treated as the amount of the excess benefit.[85] Any amount repaid as a result of correcting an excess benefit transaction shall not be held in any donor advised fund.

In general, donors and donor advisors with respect to a donor advised fund (as well as persons related to a donor or donor advisor) are treated as disqualified persons under section 4958 with respect to transactions with such donor advised fund (though not necessarily with respect to transactions with the sponsoring organization more generally).[86] An investment advisor (as well as persons related to the investment advisor) also is treated as a disqualified person under section 4958 with respect to the sponsoring organization.[87] The term "investment advisor" means, with respect to any sponsoring organization, any person (other than an employee of the sponsoring organization) who is compensated by the sponsoring organization for

[81] Sec. 4943(e)(2).

[82] Sec. 4958(c).

[83] Sec. 4958(e).

[84] For this purpose, a person is treated as related to another person if such person bears a relationship to such other person similar to the relationships described in sections 4958(f)(1)(B) and 4958(f)(1)(C).

[85] Sec. 4958(c)(2).

[86] Sec. 4958(f)(1)(E).

[87] Sec. 4958(f)(1)(F).

managing the investment of, or providing investment advice with respect to, assets maintained in donor advised funds (including pools of assets all or part of which are attributed to donor advised funds) owned by the sponsoring organization.[88]

Taxable distributions

Certain distributions from a donor advised fund are subject to tax.[89] A "taxable distribution" is any distribution from a donor advised fund to: (1) any natural person; or (2) to any other person for any purpose other than one specified in section 170(c)(2)(B) (generally, a charitable purpose) or, if for a charitable purpose, the sponsoring organization does not exercise expenditure responsibility with respect to the distribution in accordance with section 4945(h).[90] The expenditure responsibility rules generally require that an organization exert all reasonable efforts and establish adequate procedures to see that the distribution is spent solely for the purposes for which it was made, to obtain full and complete reports from the distributee on how the funds are spent, and to make full and detailed reports with respect to such expenditures to the Secretary. A taxable distribution does not in any case include a distribution to (1) an organization described in section 170(b)(1)(A) (other than to a disqualified supporting organization); (2) the sponsoring organization of such donor advised fund; or (3) to another donor advised fund.[91]

In the event of a taxable distribution, an excise tax equal to 20 percent of the amount of the distribution is imposed against the sponsoring organization. In addition, an excise tax equal to five percent of the amount of the distribution is imposed against any manager of the sponsoring organization (defined in a manner similar to the term "foundation manager" under section 4945) who knowingly approved the distribution, not to exceed $10,000 with respect to any one taxable distribution. The taxes on taxable distributions are subject to abatement under generally applicable rules.[92]

More than incidental benefit

If a donor, a donor advisor, or a person related to a donor or donor advisor of a donor advised fund provides advice as to a distribution that results in any such person receiving, directly or indirectly, a more than incidental benefit, an excise tax equal to 125 percent of the amount of such benefit is imposed against the person who advised as to the distribution, and against the recipient of the benefit. Persons subject to the tax are jointly and severally liable for the tax. In addition, if a manager of the sponsoring organization (defined in a manner similar to the term "foundation manager" under section 4945) agreed to the making of the distribution,

[88] Sec. 4958(f)(8).

[89] Sec. 4966.

[90] Sec. 4966(c)(1).

[91] Sec. 4966(c)(2).

[92] Secs. 4966(a) and (b).

knowing that the distribution would confer a more than incidental benefit on a donor, a donor advisor, or a person related to a donor or donor advisor, the manager is subject to an excise tax equal to 10 percent of the amount of such benefit, not to exceed $10,000. The taxes on more than incidental benefit are subject to abatement under generally applicable rules.[93]

Reporting and disclosure

Each sponsoring organization must 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.[94] In addition, when seeking recognition of its tax-exempt status, a sponsoring organization must disclose whether it intends to maintain donor advised funds.[95]

Description of Proposal

The proposal generally requires that contributions to donor advised funds be distributed for charitable purposes within a specified time period and imposes an excise tax in the event of a failure to make timely distributions. Specifically, in the case of a contribution that is held in a donor advised fund, the proposal imposes a tax equal to 20 percent of so much of the contribution as has not been distributed by the sponsoring organization in an eligible distribution before the beginning of the sixth (or any succeeding) taxable year beginning after the taxable year during which such contribution is made.[96]

An eligible distribution is a distribution to an organization described in section 170(b)(1)(A) (generally, to a public charity), other than a supporting organization described in section 509(a)(3) or another donor advised fund described in section 4966(d)(2). Distributions are treated as made from contributions (and any earnings attributable thereto) on a first-in, first-out basis.

The tax imposed by the proposal must be paid by the sponsoring organization.

Effective Date

The proposal generally is effective for contributions made after December 31, 2014. In the case of a contribution made before January 1, 2015, any portion of which (including any

[93] See generally sec. 4967.

[94] Sec. 6033(k).

[95] Sec. 508(f).

[96] For example, if such a contribution remains undistributed as of the beginning of the seventh taxable year following the year in which the contributions is made, a tax will be imposed for both the sixth and seventh taxable years following the contribution year.

earnings attributable thereto) is held in a donor advised fund as of such date, such portion is treated as having been contributed on such date.

4. Simplification of excise tax on private foundation investment income (sec. 5204 of the discussion draft and sec. 4940 of the Code)

Present Law

Excise tax on the net investment income of private foundations

Under section 4940(a), private foundations that are recognized as exempt from Federal income tax under section 501(a) (other than exempt operating foundations) are subject to a two-percent excise tax on their net investment income. Net investment income generally includes interest, dividends, rents, royalties (and income from similar sources), and capital gain net income, and is reduced by expenses incurred to earn this income. The two-percent rate of tax is reduced to one-percent in any year in which a foundation exceeds the average historical level of its charitable distributions. Specifically, the excise tax rate is reduced if the foundation's qualifying distributions (generally, amounts paid to accomplish exempt purposes)[97] equal or exceed the sum of (1) the amount of the foundation's assets for the taxable year multiplied by the average percentage of the foundation's qualifying distributions over the five taxable years immediately preceding the taxable year in question, and (2) one percent of the net investment income of the foundation for the taxable year.[98] In addition, the foundation cannot have been subject to tax in any of the five preceding years for failure to meet minimum qualifying distribution requirements in section 4942.

Private foundations that are not exempt from tax under section 501(a), such as certain charitable trusts, are subject to an excise tax under section 4940(b). The tax is equal to the excess of the sum of the excise tax that would have been imposed under section 4940(a) if the foundation were tax exempt and the amount of the tax on unrelated business income that would have been imposed if the foundation were tax exempt, over the income tax imposed on the foundation under subtitle A of the Code.

Private foundations are required to make a minimum amount of qualifying distributions each year to avoid tax under section 4942. The minimum amount of qualifying distributions a foundation has to make to avoid tax under section 4942 is reduced by the amount of section 4940 excise taxes paid.[99]

[97] Sec. 4942(g).

[98] Sec. 4940(e).

[99] Sec. 4942(d)(2).

Exempt operating foundations

Exempt operating foundations are exempt from the tax on the net investment income of private foundations.[100] Exempt operating foundations generally include organizations such as museums or libraries that devote their assets to operating charitable programs but have difficulty meeting the "public support" tests necessary not to be classified as a private foundation. To be an exempt operating foundation, an organization must: (1) be an operating foundation (as defined in section 4942(j)(3)); (2) be publicly supported for at least 10 taxable years; (3) have a governing body no more than 25 percent of whom are disqualified persons and that is broadly representative of the general public; and (4) have no officers who are disqualified persons.[101]

Description of Proposal

The proposal replaces the two rates of excise tax on tax-exempt private foundations with a single rate of tax of one percent. Thus, under the proposal, a tax-exempt private foundation generally is subject to an excise tax of one percent on its net investment income. A taxable private foundation is subject to an excise tax equal to the excess (if any) of the sum of the one-percent net investment income excise tax and the amount of the tax on unrelated business income (both calculated as if the foundation were tax-exempt), over the income tax imposed on the foundation. The proposal repeals the special reduced excise tax rate for private foundations that exceed their historical level of qualifying distributions.

The proposal also repeals the exception for exempt operating foundations from the tax on the net investment income of private foundations.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

5. Repeal of exception for private operating foundation failure to distribute income (sec. 5205 of the discussion draft and sec. 4942 of the Code)

Present Law

Public charities and private foundations

An organization qualifying for tax-exempt status under section 501(c)(3) is further classified as either a public charity or a private foundation. An organization may qualify as a public charity in several ways.[102] Certain organizations are classified as public charities *per se*, regardless of their sources of support. These include churches, certain schools, hospitals and

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[100] Sec. 4940(d)(1).

[101] Sec. 4940(d)(2).

[102] The Code does not expressly define the term "public charity," but rather provides exceptions to those entities that are treated as private foundations.

other medical organizations, certain organizations providing assistance to colleges and universities, and governmental units.[103] Other organizations qualify as public charities because they are broadly publicly supported. First, a charity may qualify as publicly supported if at least one-third of its total support is from gifts, grants or other contributions from governmental units or the general public.[104] Alternatively, it may qualify as publicly supported if it receives more than one-third of its total support from a combination of gifts, grants, and contributions from governmental units and the public *plus* revenue arising from activities related to its exempt purposes (*e.g.*, fee for service income). In addition, this category of public charity must not rely excessively on endowment income as a source of support.[105] A supporting organization, *i.e.*, an organization that provides support to another section 501(c)(3) entity that is not a private foundation and meets certain other requirements of the Code, also is classified as a public charity.[106]

A section 501(c)(3) organization that does not fit within any of the above categories is a private foundation. In general, private foundations receive funding from a limited number of sources (*e.g.*, an individual, a family, or a corporation).

The deduction for charitable contributions to private foundations is in some instances less generous than the deduction for charitable contributions to public charities. In addition, private foundations are subject to a number of operational rules and restrictions that do not apply to public charities.[107]

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[103] Sec. 509(a)(1) (referring to sections 170(b)(1)(A)(i) through (iv) for a description of these organizations).

[104] Treas. Reg. sec. 1.170A-9(f)(2). Failing this mechanical test, the organization may qualify as a public charity if it passes a "facts and circumstances" test. Treas. Reg. sec. 1.170A-9(f)(3).

[105] To meet this requirement, the organization must normally receive more than one-third of its support from a combination of (1) gifts, grants, contributions, or membership fees and (2) certain gross receipts from admissions, sales of merchandise, performance of services, and furnishing of facilities in connection with activities that are related to the organization's exempt purposes. Sec. 509(a)(2)(A). In addition, the organization must not normally receive more than one-third of its public support in each taxable year from the sum of (1) gross investment income and (2) the excess of unrelated business taxable income as determined under section 512 over the amount of unrelated business income tax imposed by section 511. Sec. 509(a)(2)(B).

[106] Sec. 509(a)(3). Supporting organizations are further classified as Type I, II, or III depending on the relationship they have with the organizations they support. Supporting organizations must support public charities listed in one of the other categories (*i.e.*, *per se* public charities, broadly supported public charities, or revenue generating public charities), and they are not permitted to support other supporting organizations or testing for public safety organizations.

Organizations organized and operated exclusively for testing for public safety also are classified as public charities. Sec. 509(a)(4). Such organizations, however, are not eligible to receive deductible charitable contributions under section 170.

[107] Unlike public charities, private foundations are subject to tax on their net investment income at a rate of two percent (one percent in some cases). Sec. 4940. Private foundations also are subject to more restrictions on their activities than are public charities. For example, private foundations are prohibited from engaging in self-

Tax on failure to distribute income by private nonoperating foundations

Private nonoperating foundations are required to pay out a minimum amount each year as qualifying distributions.[108] In general, a qualifying distribution is an amount paid to accomplish one or more of the organization's exempt purposes, including reasonable and necessary administrative expenses.[109] Failure to pay out the minimum required amount results in an initial excise tax on the foundation of 30 percent of the undistributed amount. An additional tax of 100 percent of the undistributed amount applies if an initial tax is imposed and the required distributions have not been made by the end of the applicable taxable period.[110] A foundation may include as a qualifying distribution the salaries, occupancy expenses, travel costs, and other reasonable and necessary administrative expenses that the foundation incurs in operating a grant program. A qualifying distribution also includes any amount paid to acquire an asset used (or held for use) directly in carrying out one or more of the organization's exempt purposes and certain amounts set aside for exempt purposes.[111]

Private operating foundations

The tax on failure to distribute income does not apply to the undistributed income of a private foundation for any taxable year for which it is an operating foundation.[112] Private operating foundations generally operate their own charitable programs directly, rather than serving primarily as a grantmaking entity.

Private operating foundations must satisfy several tests designed to distinguish them from nonoperating (grantmaking) foundations. First, an operating foundation generally must make qualifying distributions for the direct conduct of activities that are related to its exempt purpose (as opposed to making such distributions in the form of grants to other charities) equal to 85 percent of the lesser of its adjusted net income or its minimum investment return, each as defined under section 4942.[113] In addition, an operating foundation must satisfy one of the following three alternative tests: (1) an asset test, under which substantially more than half of the

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dealing transactions (sec. 4941), are required to make a minimum amount of charitable distributions each year, (sec. 4942), are limited in the extent to which they may control a business (sec. 4943), may not make speculative investments (sec. 4944), and may not make certain expenditures (sec. 4945). Violations of these rules result in excise taxes on the foundation and, in some cases, may result in excise taxes on the managers of the foundation.

[108] Sec. 4942.

[109] Sec. 4942(g)(1)(A).

[110] Sec. 4942(a) and (b). Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

[111] Sec. 4942(g)(1)(B) and 4942(g)(2). In general, an organization is permitted to adjust the distributable amount in those cases where distributions during the five preceding years have exceeded the payout requirements. Sec. 4942(i).

[112] Sec. 4942(a)(1).

[113] Sec. 4942(j)(3)(A); Treas. Reg. sec. 53.4942(b)-1(c).

organization's assets (generally, 65 percent) are devoted to the direct conduct of exempt activities or to functionally related businesses; (2) an endowment test, under which the organization normally makes qualifying distributions for the direct conduct of activities related to its exempt purpose in an amount not less than two-thirds of its minimum investment return; or (3) a support test, under which the organization must meet certain measures to show that it receives public support.[114]

Description of Proposal

The proposal repeals the exception for private operating foundations from the excise tax on a private foundation's failure to distribute income under section 4942, thereby extending the excise tax to private operating foundations.[115]

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

6. Excise tax based on investment income of private colleges and universities (sec. 5206 of the discussion draft and new sec. 4969 of the Code)

Present Law

Public charities and private foundations

An organization qualifying for tax-exempt status under section 501(c)(3) is further classified as either a public charity or a private foundation. An organization may qualify as a public charity in several ways.[116] Certain organizations are classified as public charities *per se*, regardless of their sources of support. These include churches, certain schools, hospitals and other medical organizations, certain organizations providing assistance to colleges and universities, and governmental units.[117] Other organizations qualify as public charities because they are broadly publicly supported. First, a charity may qualify as publicly supported if at least one-third of its total support is from gifts, grants or other contributions from governmental units or the general public.[118] Alternatively, it may qualify as publicly supported if it receives more

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[114] Sec. 4942(j)(3)(B).

[115] The proposal does not modify the rules for deducting charitable contributions to private operating foundations. As a conforming amendment to the Code, the proposal moves the definition of an operating foundation from section 4942 to section 170(b)(1).

[116] The Code does not expressly define the term "public charity," but rather provides exceptions to those entities that are treated as private foundations.

[117] Sec. 509(a)(1) (referring to sections 170(b)(1)(A)(i) through (iv) for a description of these organizations).

[118] Treas. Reg. sec. 1.170A-9(f)(2). Failing this mechanical test, the organization may qualify as a public charity if it passes a "facts and circumstances" test. Treas. Reg. sec. 1.170A-9(f)(3).

than one-third of its total support from a combination of gifts, grants, and contributions from governmental units and the public *plus* revenue arising from activities related to its exempt purposes (*e.g.*, fee for service income). In addition, this category of public charity must not rely excessively on endowment income as a source of support.[119] A supporting organization, *i.e.*, an organization that provides support to another section 501(c)(3) entity that is not a private foundation and meets the requirements of the Code, also is classified as a public charity.[120]

A section 501(c)(3) organization that does not fit within any of the above categories is a private foundation. In general, private foundations receive funding from a limited number of sources (*e.g.*, an individual, a family, or a corporation).

The deduction for charitable contributions to private foundations is in some instances less generous than the deduction for charitable contributions to public charities. In addition, private foundations are subject to a number of operational rules and restrictions that do not apply to public charities.[121]

Excise tax on investment income of private foundations

Under section 4940(a), private foundations that are recognized as exempt from Federal income tax under section 501(a) (other than exempt operating foundations)[122] are subject to a

[119] To meet this requirement, the organization must normally receive more than one-third of its support from a combination of (1) gifts, grants, contributions, or membership fees and (2) certain gross receipts from admissions, sales of merchandise, performance of services, and furnishing of facilities in connection with activities that are related to the organization's exempt purposes. Sec. 509(a)(2)(A). In addition, the organization must not normally receive more than one-third of its public support in each taxable year from the sum of (1) gross investment income and (2) the excess of unrelated business taxable income as determined under section 512 over the amount of unrelated business income tax imposed by section 511. Sec. 509(a)(2)(B).

[120] Sec. 509(a)(3). Supporting organizations are further classified as Type I, II, or III depending on the relationship they have with the organizations they support. Supporting organizations must support public charities listed in one of the other categories (*i.e.*, *per se* public charities, broadly supported public charities, or revenue generating public charities), and they are not permitted to support other supporting organizations or testing for public safety organizations.

Organizations organized and operated exclusively for testing for public safety also are classified as public charities. Sec. 509(a)(4). Such organizations, however, are not eligible to receive deductible charitable contributions under section 170.

[121] Unlike public charities, private foundations are subject to tax on their net investment income at a rate of two percent (one percent in some cases). Sec. 4940. Private foundations also are subject to more restrictions on their activities than are public charities. For example, private foundations are prohibited from engaging in self-dealing transactions (sec. 4941), are required to make a minimum amount of charitable distributions each year, (sec. 4942), are limited in the extent to which they may control a business (sec. 4943), may not make speculative investments (sec. 4944), and may not make certain expenditures (sec. 4945). Violations of these rules result in excise taxes on the foundation and, in some cases, may result in excise taxes on the managers of the foundation.

[122] Exempt operating foundations are exempt from the section 4940 tax. Sec. 4940(d)(1). Exempt operating foundations generally include organizations such as museums or libraries that devote their assets to operating charitable programs but have difficulty meeting the "public support" tests necessary not to be classified as a private foundation. To be an exempt operating foundation, an organization must: (1) be an operating foundation

two-percent excise tax on their net investment income. Net investment income generally includes interest, dividends, rents, royalties (and income from similar sources), and capital gain net income, and is reduced by expenses incurred to earn this income. The two-percent rate of tax is reduced to one-percent in any year in which a foundation exceeds the average historical level of its charitable distributions. Specifically, the excise tax rate is reduced if the foundation's qualifying distributions (generally, amounts paid to accomplish exempt purposes)[123] equal or exceed the sum of (1) the amount of the foundation's assets for the taxable year multiplied by the average percentage of the foundation's qualifying distributions over the five taxable years immediately preceding the taxable year in question, and (2) one percent of the net investment income of the foundation for the taxable year.[124] In addition, the foundation cannot have been subject to tax in any of the five preceding years for failure to meet minimum qualifying distribution requirements in section 4942.[125]

Private foundations that are not exempt from tax under section 501(a), such as certain charitable trusts, are subject to an excise tax under section 4940(b). The tax is equal to the excess of the sum of the excise tax that would have been imposed under section 4940(a) if the foundation were tax exempt and the amount of the tax on unrelated business income that would have been imposed if the foundation were tax exempt, over the income tax imposed on the foundation under subtitle A of the Code.

Private foundations are required to make a minimum amount of qualifying distributions each year to avoid tax under section 4942. The minimum amount of qualifying distributions a foundation has to make to avoid tax under section 4942 is reduced by the amount of section 4940 excise taxes paid.[126]

Private colleges and universities

Private colleges and universities generally are treated as public charities rather than private foundations[127] and thus are not subject to the private foundation excise tax on net investment income.

(as defined in section 4942(j)(3)); (2) be publicly supported for at least 10 taxable years; (3) have a governing body no more than 25 percent of whom are disqualified persons and that is broadly representative of the general public; and (4) have no officers who are disqualified persons. Sec. 4940(d)(2).

[123] Sec. 4942(g).

[124] Sec. 4940(e).

[125] Under a separate proposal, the private foundation excise tax would be simplified by replacing the two-tier rate structure with a single-rate tax set at one percent.

[126] Sec. 4942(d)(2).

[127] Secs. 509(a)(1) and 170(b)(1)(A)(ii).

Description of Proposal

The proposal imposes an excise tax on an applicable educational institution for each taxable year equal to one percent of the net investment income of the institution for the taxable year. Net investment income is determined using rules similar to the rules of section 4940(c) (relating to the net investment income of a private foundation).

For purposes of the proposal, an applicable educational institution is an institution: (1) that is an eligible education institution as described in section 25A of the Code (as amended by a separate proposal)[128]; (2) that is not described in the first section of section 511(a)(2)(B) of the Code (generally describing State colleges and universities); and (3) the aggregate fair market value of the assets of which at the end of the preceding taxable year (other than those assets which are used, or held for use, directly in carrying out the institution's exempt purpose) is at least $100,000 per student. For this purpose, the number of students of an institution is based on the daily average number of full-time students attending the institution, with part-time students being taken into account on a full-time student equivalent basis.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

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[128] Section 25A, as amended by a separate proposal, defines an eligible educational institution as an institution (1) which is described in section 481 of the Higher Education Act of 1965 (20 U.S.C. 1088), as in effect on August 5, 1977, and (2) which is eligible to participate in a program under title IV of such Act.

D. Requirements for Organizations Exempt From Tax

1. Repeal of tax-exempt status for professional sports leagues (sec. 5301 of the discussion draft and sec. 501(c)(6) of the Code)

Present Law

Tax exemption for section 501(c)(6) organizations

Section 501(c)(6) provides tax exempt status for business leagues and certain other organizations not organized for profit, no part of the net earnings of which inures to the benefit of any private shareholder or individual. A business league is an association of persons having some common business interest, the purpose of which is to promote such common interest and not to engage in a regular business of a kind ordinarily carried on for profit.[129] Such an organization may not have as its primary activity performing "particular services" for members.[130] Contributions to these types of organizations are not deductible as charitable contributions; however, they may be deductible as trade or business expenses if ordinary and necessary in the conduct of the taxpayer's business. Many organizations known as "trade associations" may qualify for exempt status under this provision.

Professional sports leagues

Since 1966, section 501(c)(6) has included language exempting from tax "professional football leagues (whether or not administering a pension fund for football players)." The Internal Revenue Service has interpreted this language as applying not only to professional football leagues, but to all professional sports leagues.[131]

Description of Proposal

The proposal strikes from section 501(c)(6) the phrase "professional football leagues (whether or not administering a pension fund for football players)." In addition, the proposal amends section 501(c)(6) to provide affirmatively that section 501(c)(6) "shall not apply to any professional sports league (whether or not administering a pension fund for players)."

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[129] Treas. Reg. sec. 1.501(c)(6)-1.

[130] Treas. Reg. sec. 1.501(c)(6)-1.

[131] See General Counsel Memorandum 38179, November 29, 1979 ("We continue to believe that professional sports leagues, including football leagues, do not qualify for exemption if the ordinary standards of section 501(c)(6) are applied. However, while the answer is far from clear, we have concluded upon reflection that the specific exemption of football leagues in 1966 can be viewed as providing support for recognition of exemption of all professional sports leagues as a unique category of organizations under section 501(c)(6). Since other professional sports leagues are indistinguishable in any meaningful way from football leagues, we think it is fair to conclude that by formally blessing the exemption it knew football leagues had historically enjoyed, Congress implicitly recognized a unique historical category of exemption under section 501(c)(6). The specific enumeration of football leagues can be viewed as merely exemplary of the category thus recognized, and as necessitated only by the problem of insuring that football's pension and merger arrangement would not endanger its exemption").

Effective Date

The proposal is effective for taxable years beginning after December 31, 2014.

2. Repeal of exemption from tax for certain insurance companies and CO-OP health insurance issuers (sec. 5302 of the discussion draft and sec. 501 of the Code)

Present Law

Section 501(c)(15) exempts from tax: (1) stock property and casualty insurance companies with gross receipts that do not exceed $600,000, more than 50 percent of which consist of premiums; and (2) mutual property and casualty insurance companies with gross receipts that do not exceed $150,000, more than 35 percent of which consist of premiums.

Qualified nonprofit health insurance issuers (within the meaning of section 1322 of the Patient Protection and Affordable Care Act) that have received a loan or grant under the CO-OP program under such section are exempt from tax under section 501(c)(29) of the Code.

Description of Proposal

The provision strikes sections 501(c)(15) and 501(c)(29). Organizations in existence prior to the effective date are provided transition relief as follows. Organizations are given a fresh start with respect to changes in accounting methods resulting from the change from tax-exempt to taxable status. No adjustment is made under section 481 on account of an accounting method change. The basis of assets of such organizations is equal, for purposes of determining gain or loss, to the amount of the assets' fair market value on the first day of the organization's taxable year beginning after the effective date.

Effective Date

The provision applies to taxable years beginning after December 31, 2014.

3. In-State requirement for certain tax-exempt workmen's compensation insurance organizations (sec. 5303 of the discussion draft and sec. 501(c)(27) of the Code)

Present Law

Workers' compensation reinsurance organizations

Section 501(c)(27)(A) provides tax-exempt status to any membership organization that is established by a State before June 1, 1996, exclusively to reimburse its members for workers' compensation insurance losses, and that satisfies certain other conditions. A State must require that the membership of the organization consist of all persons who issue insurance covering workers' compensation losses in such State, and all persons and governmental entities who self-insure against such losses. In addition, the organization must operate as a nonprofit organization by returning surplus income to members or to workers' compensation policyholders on a periodic basis and by reducing initial premiums in anticipation of investment income.

State workmen's compensation act companies

Section 501(c)(27)(B) provides tax-exempt status for any organization that is created by State law, and organized and operated exclusively to provide workmen's compensation insurance and related coverage that is incidental to workmen's compensation insurance, and that meets certain additional requirements. The workmen's compensation insurance must be required by State law, or be insurance with respect to which State law provides significant disincentives if it is not purchased by an employer (such as loss of exclusive remedy or forfeiture of affirmative defenses such as contributory negligence). The organization must provide workmen's compensation to any employer in the State (for employees in the State or temporarily assigned out-of-State) seeking such insurance and meeting other reasonable requirements. The State must either extend its full faith and credit to the initial debt of the organization or provide the initial operating capital of such organization. For this purpose, the initial operating capital can be provided by providing the proceeds of bonds issued by a State authority; the bonds may be repaid through exercise of the State's taxing authority, for example. For periods after the date of enactment (August 5, 1997), either the assets of the organization must revert to the State upon dissolution, or State law must not permit the dissolution of the organization absent an act of the State legislature. Should dissolution of the organization become permissible under applicable State law, then the requirement that the assets of the organization revert to the State upon dissolution applies. Finally, the majority of the board of directors (or comparable oversight body) of the organization must be appointed by an official of the executive branch of the State or by the State legislature, or by both.

Description of Proposal

The proposal amends section 501(c)(27)(B) to limit tax-exempt status under that subparagraph to organizations that offer no insurance other than workmen's compensation insurance offered to any employer in the State (for employees in the State or temporarily assigned out-of-State).

Effective Date

The proposal is effective for policies issued, and renewals, after December 31, 2014.

4. Repeal of Type II and Type III supporting organizations (sec. 5304 of the discussion draft and sec. 509(a)(3) of the Code)

Present Law

Requirements for section 501(c)(3) tax-exempt status

Charitable organizations, *i.e.*, organizations described in section 501(c)(3), generally are exempt from Federal income tax and are eligible to receive tax deductible contributions. A charitable organization must operate primarily in pursuance of one or more tax-exempt purposes constituting the basis of its tax exemption.[132] In order to qualify as operating primarily for a purpose described in section 501(c)(3), an organization must satisfy the following operational requirements: (1) its net earnings may not inure to the benefit of any person in a position to influence the activities of the organization; (2) it must operate to provide a public benefit, not a private benefit;[133] (3) it may not be operated primarily to conduct an unrelated trade or business;[134] (4) it may not engage in substantial legislative lobbying; and (5) it may not participate or intervene in any political campaign.

Classification of section 501(c)(3) organizations

In general

Section 501(c)(3) organizations are classified either as "public charities" or "private foundations."[135] Private foundations generally are defined under section 509(a) as all organizations described in section 501(c)(3) other than an organization granted public charity status by reason of: (1) being a specified type of organization (*i.e.*, churches, educational institutions, hospitals and certain other medical organizations, certain organizations providing assistance to colleges and universities, or a governmental unit); (2) receiving a substantial part of its support from governmental units or direct or indirect contributions from the general public; or (3) providing support to another section 501(c)(3) entity that is not a private foundation. In contrast to public charities, private foundations generally are funded from a limited number of sources (*e.g.*, an individual, family, or corporation). Donors to private foundations and persons related to such donors together often control the operations of private foundations.

Because private foundations receive support from, and typically are controlled by, a small number of supporters, private foundations are subject to a number of anti-abuse rules and excise taxes not applicable to public charities.[136] Public charities also have certain advantages over private foundations regarding the deductibility of contributions.

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[132] Treas. Reg. sec. 1.501(c)(3)-1(c)(1). The Code specifies such purposes as religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster international amateur sports competition, or for the prevention of cruelty to children or animals. In general, an organization is organized and operated for charitable purposes if it provides relief for the poor and distressed or the underprivileged. Treas. Reg. sec. 1.501(c)(3)-1(d)(2).

[133] Treas. Reg. sec. 1.501(c)(3)-1(d)(1)(ii).

[134] Treas. Reg. sec. 1.501(c)(3)-1(e)(1). Conducting a certain level of unrelated trade or business activity will not jeopardize tax-exempt status.

[135] Sec. 509(a). Private foundations are either private operating foundations or private non-operating foundations. In general, private operating foundations operate their own charitable programs in contrast to private non-operating foundations, which generally are grant-making organizations. Most private foundations are non-operating foundations.

[136] Secs. 4940 - 4945.

Supporting organizations (section 509(a)(3))

The Code provides that certain "supporting organizations" (in general, organizations that provide support to another section 501(c)(3) organization that is not a private foundation) are classified as public charities rather than private foundations.[137] To qualify as a supporting organization, an organization must meet all three of the following tests: (1) it must be organized and at all times operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more "publicly supported organizations"[138] (the "organizational and operational tests");[139] (2) it must be operated, supervised, or controlled by or in connection with one or more publicly supported organizations (the "relationship test");[140] and (3) it must not be controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more publicly supported organizations (the "lack of outside control test").[141]

To satisfy the relationship test, a supporting organization must hold one of three statutorily described close relationships with the supported organization. The organization must be: (1) operated, supervised, or controlled by a publicly supported organization (commonly referred to as "Type I" supporting organizations); (2) supervised or controlled in connection with a publicly supported organization ("Type II" supporting organizations); or (3) operated in connection with a publicly supported organization ("Type III" supporting organizations).[142]

Type I supporting organizations

In the case of supporting organizations that are operated, supervised, or controlled by one or more publicly supported organizations (Type I supporting organizations), one or more supported organizations must exercise a substantial degree of direction over the policies, programs, and activities of the supporting organization.[143] The relationship between the Type I supporting organization and the supported organization generally is comparable to that of a parent and subsidiary. The requisite relationship may be established by the fact that a majority of the officers, directors, or trustees of the supporting organization are appointed or elected by

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[137] Sec. 509(a)(3).

[138] In general, supported organizations of a supporting organization must be publicly supported charities described in sections 509(a)(1) or (a)(2).

[139] Sec. 509(a)(3)(A).

[140] Sec. 509(a)(3)(B).

[141] Sec. 509(a)(3)(C).

[142] Treas. Reg. sec. 1.509(a)-4(f)(2).

[143] Treas. Reg. sec. 1.509(a)-4(g)(1)(i).

the governing body, members of the governing body, officers acting in their official capacity, or the membership of one or more publicly supported organizations.[144]

Type II supporting organizations

Type II supporting organizations are supervised or controlled in connection with one or more publicly supported organizations. Rather than the parent-subsidiary relationship characteristic of Type I organizations, the relationship between a Type II organization and its supported organizations is more analogous to a brother-sister relationship. In order to satisfy the Type II relationship requirement, generally there must be common supervision or control by the persons supervising or controlling both the supporting organization and the publicly supported organizations.[145] An organization generally is not considered to be "supervised or controlled in connection with" a publicly supported organization merely because the supporting organization makes payments to the publicly supported organization, even if the obligation to make payments is enforceable under state law.[146]

Type III supporting organizations

Type III supporting organizations are "operated in connection with" one or more publicly supported organizations. To satisfy the "operated in connection with" relationship, Treasury regulations require that the supporting organization be responsive to, and significantly involved in the operations of, the publicly supported organization. This relationship is deemed to exist where the supporting organization satisfies a notification requirement, a "responsiveness test," and an "integral part test."[147] An organization is not operated in connection with one or more supported organizations if it supports any supported organization organized outside of the United States.[148]

To satisfy the notification requirement for a taxable year, a Type III supporting organization must provide the following documents to each of its supported organizations: (1) a written notice to a principal officer of the supported organization describing the type and amount of all support the supporting organization provided during the supporting organization's preceding taxable year; (2) a copy of the supporting organization's most recently filed Form 990 (or other annual information return); and (3) a copy of the supporting organization's current governing documents, unless such documents have been previously provided and not

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[144] *Ibid.*

[145] Treas. Reg. sec. 1.509(a)- 4(h)(1).

[146] Treas. Reg. sec. 1.509(a)-4(h)(2).

[147] Treas. Reg. sec. 1.509(a)-4(i)(1).

[148] Treas. Reg. sec. 1.509(a)-4(i)(10).

subsequently amended.[149] The notification documents for a taxable year must be provided by the last day of the fifth calendar month following the close of the taxable year.[150]

In general, the responsiveness test requires that the Type III supporting organization be responsive to the needs or demands of the publicly supported organizations.[151] A supporting organization generally satisfies the test by demonstrating that: (1)(a) one or more of its officers, directors, or trustees are elected or appointed by the officers, directors, trustees, or membership of the supported organization; (b) one or more members of the governing bodies of the publicly supported organizations are also officers, directors, or trustees of, or hold other important offices in, the supporting organization; or (c) the officers, directors, or trustees of the supporting organization maintain a close continuous working relationship with the officers, directors, or trustees of the publicly supported organizations;[152] and (2) by reason of such arrangement, the officers, directors, or trustees of the supported organization have a significant voice in the investment policies of the supporting organization, the timing and manner of making grants, the selection of grant recipients by the supporting organization, and otherwise directing the use of the income or assets of the supporting organization.[153]

For purposes of the integral part test, Type III supporting organizations are further classified as "functionally integrated" or "non-functionally integrated."

Functionally integrated Type III supporting organizations.−To satisfy the integral part test as a functionally integrated Type III supporting organization, an organization must establish that: (1)(a) substantially all of its activities directly further the exempt purposes of one or more supported organizations by performing the functions of, or carrying out the purposes of, such organizations; and (b) these activities, but for the involvement of the supporting organization, normally would be engaged in by the publicly supported organizations themselves;[154] (2) it is the parent of each of its supported organizations;[155] or (3) it supports a governmental organization.[156]

[149] Treas. Reg. sec. 1.509(a)-4(i)(2)(i).

[150] Treas. Reg. sec. 1.509(a)-4(i)(2)(iii).

[151] Treas. Reg. sec. 1.509(a)-4(i)(3)(i).

[152] Treas. Reg. sec. 1.509(a)-4(i)(3)(ii).

[153] Treas. Reg. sec. 1.509(a)-4(i)(3)(iii). For an organization that was supporting or benefiting one or more publicly supported organizations before November 20, 1970, additional facts and circumstances, such as an historic and continuing relationship between organizations, also may be taken into consideration to establish compliance with either of the responsiveness tests. Treas. Reg. sec. 1.509(a)-4(i)(3)(v).

[154] Treas. Reg. secs. 1.509(a)-4(i)(4)(i)(A) & -4(i)(4)(ii).

[155] Treas. Reg. secs. 1.509(a)-4(i)(4)(i)(B) & -4(i)(4)(iii).

[156] Treas. Reg. sec. 1.509(a)-4(i)(4)(i)(C). Regulations describing this means of satisfying the integral support test have been reserved. Treas. Reg. sec. 1.509(a)-4(i)(4)(iv).

Non-functionally integrated Type III supporting organizations.−To satisfy the integral part test as a non-functionally integrated Type III supporting organization, an organization generally must satisfy a distribution requirement and an attentiveness requirement.[157] An organization satisfies the distribution requirement for a taxable year if it distributes to or for the use of one or more supported organizations an amount equal to or greater than the supporting organization's distributable amount for the taxable year.[158] The distributable amount generally is the greater of 85 percent of the supporting organization's adjusted net income or 3.5 percent of the organization's non-exempt use assets for the immediately preceding tax year.[159] An organization satisfies the attentiveness requirement if: (1) it distributes to its supported organization at least 10 percent of the supported organization's total support; (2) the amount of support received from the supporting organization is necessary to avoid the interruption of the carrying on of a particular function or activity of the supported organization; or (3) based on facts and circumstances, the amount of support received from the supporting organization is a sufficient part of a supported organization's total support to ensure attentiveness.[160]

Description of Proposal

The proposal limits supporting organization status to organizations that are operated, supervised, or controlled by one or more publicly supported organizations (present law Type I supporting organizations). An organization may no longer satisfy the relationship test by being supervised or controlled in connection with one or more publicly supported organizations (Type II supporting organizations) or by being operated in connection with one or more publicly supported organizations (Type III supporting organizations).

Effective Date

The proposal generally is effective on the date of enactment. For Type II and Type III supporting organizations recognized as of the date of enactment as exempt from tax under section 501(a) as an organization described in section 501(c)(3), the proposal is effective for taxable years beginning after December 31, 2015.

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[157] Treas. Reg. sec. 1.509(a)-4(i)(5)(i)(A). Special rules exist for certain pre-November 20, 1970 trusts. See Treas. Reg. secs. 1.509(a)-4(i)(5)(i)(B) & -4(i)(9).

[158] Treas. Reg. sec. 1.509(a)-4(i)(5)(ii).

[159] Treas. Reg. secs. 1.509(a)-4T(i)(5)(ii)(B) & (C).

[160] Treas. Reg. sec. 1.509(a)-4(i)(5)(iii)(B).