DESCRIPTION OF AN AMENDMENT IN THE NATURE OF A SUBSTITUTE TO H.R. 7, THE "COMMUNITY SOLUTIONS ACT OF 2001"

Scheduled for Markup
By the
HOUSE COMMITTEE ON WAYS AND MEANS
on July 11, 2001

Prepared by
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JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The House Committee on Ways and Means has scheduled a markup on July 11, 2001, on the tax and individual development account provisions of H.R. 7, the "Community Solutions Act of 2001." This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of an amendment in the nature of a substitute to the tax and individual development account provisions of H.R. 7.

[1] This document may be cited as follows: Joint Committee on Taxation, *Description of an Amendment in the Nature of a Substitute to H.R. 7, the "Community Solutions Act of 2001"* (JCX-58-01), July 10, 2001.

I. CHARITABLE DEDUCTION FOR NONITEMIZERS

Present Law

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and the fair market value of property contributed to a charity described in section 501(c)(3) or a Federal, State, or local governmental entity. The deduction also is allowed for purposes of calculating alternative minimum taxable income.

The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.[2]

A taxpayer who takes the standard deduction (i.e., who does not itemize deductions) may not take a separate deduction for charitable contributions.[3]

A payment to a charity (regardless of whether it is termed a "contribution") in exchange for which the donor receives an economic benefit is not deductible, except to the extent that the donor can demonstrate that the payment exceeds the fair market value of the benefit received from the charity. To facilitate distinguishing charitable contributions from purchases of goods or services from charities, present law provides that no charitable contribution deduction is allowed for a separate contribution of $250 or more unless the donor obtains a contemporaneous written acknowledgement of the contribution from the charity indicating whether the charity provided any good or service (and an estimate of the value of any such good or service) to the taxpayer in consideration for the contribution.[4] In addition, present law requires that any charity that receives a contribution exceeding $75 made partly as a gift and partly as consideration for goods or services furnished by the charity (a "quid pro quo" contribution) is required to inform the contributor in writing of an estimate of the value of the goods or services furnished by the charity and that only the portion exceeding the value of the goods or services is deductible as a charitable contribution.[5]

Under present law, total deductible contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer's contribution base, which is the taxpayer's adjusted

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[2] Secs. 170(b) and (e).

[3] Sec. 170(a). The Economic Recovery Tax Act of 1981 adopted a temporary provision that permitted individual taxpayers who did not itemize income tax deductions to claim a deduction from gross income for a specified percentage of their charitable contributions. The maximum deduction was $25 for 1982 and 1983, $75 for 1984, 50 percent of the amount of the contribution for 1985, and 100 percent of the amount of the contribution for 1986. The nonitemizer deduction terminated after 1986.

[4] Sec. 170(f)(8).

[5] Sec. 6115.

gross income for a taxable year (disregarding any net operating loss carryback). To the extent a taxpayer has not exceeded the 50-percent limitation, (1) contributions of capital gain property to public charities generally may be deducted up to 30 percent of the taxpayer's contribution base, (2) contributions of cash to private foundations and certain other charitable organizations generally may be deducted up to 30 percent of the taxpayer's contribution base, and (3) contributions of capital gain property to private foundations and certain other charitable organizations generally may be deducted up to 20 percent of the taxpayer's contribution base.

Contributions by individuals in excess of the 50-percent, 30-percent, and 20-percent limit may be carried over and deducted over the next five taxable years, subject to the relevant percentage limitations on the deduction in each of those years.

In addition to the percentage limitations imposed specifically on charitable contributions, present law imposes a reduction on most itemized deductions, including charitable contribution deductions, for taxpayers with adjusted gross income in excess of a threshold amount, which is indexed annually for inflation. The threshold amount for 2001 is $132,950 ($66,475 for married individuals filing separate returns). For those deductions that are subject to the limit, the total amount of itemized deductions is reduced by 3 percent of adjusted gross income over the threshold amount, but not by more than 80 percent of itemized deductions subject to the limit. Beginning in 2006, the Economic Growth and Tax Relief Reconciliation Act of 2001 phases-out the overall limitation on itemized deductions for all taxpayers. The overall limitation on itemized deductions is reduced by one-third in taxable years beginning in 2006 and 2007, and by two-thirds in taxable years beginning in 2008 and 2009. The overall limitation on itemized deductions is eliminated for taxable years beginning after December 31, 2009; however this elimination of the limitation sunsets on December 31, 2010.

Description of Proposal

In the case of an individual taxpayer who does not itemize deductions, the proposal would allow a deduction from adjusted gross income for charitable contributions paid in cash. This deduction would be allowed in addition to the standard deduction and would be calculated as the lesser of (i) the amount allowable to itemizers as a charitable deduction for cash contributions and (ii) an applicable amount. The new deduction would generally be subject to the tax rules normally governing charitable deductions, such as the substantiation requirements and carryforward rules. For taxpayers taking a deduction of the applicable amount, the portion of contributions in excess of the applicable amount could not be carried forward. The deduction would be allowed in computing alternative minimum taxable income.

The applicable amount would be $25 ($50 in the case of a joint return) in 2002 and 2003, $50 ($100 in the case of a joint return) in 2004 through 2006, $75 ($150 in the case of a joint return) in 2007 through 2009, and $100 ($200 in the case of a joint return) in 2010 and thereafter.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 2001.

II. TAX-FREE DISTRIBUTIONS FROM INDIVIDUAL RETIREMENT ARRANGEMENTS FOR CHARITABLE PURPOSES

Present Law

In general

If an amount withdrawn from a traditional individual retirement arrangement ("IRA") or a Roth IRA is donated to a charitable organization, the rules relating to the tax treatment of withdrawals from IRAs apply and the charitable contribution is subject to the normally applicable limitations on deductibility of such contributions.

Charitable contributions

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and the fair market value of property contributed to an organization described in section 170(c), including charities and Federal, State, and local governmental entities. The deduction also is allowed for purposes of calculating alternative minimum taxable income.

The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.[6]

A payment to a charity (regardless of whether it is termed a "contribution") in exchange for which the donor receives an economic benefit is not deductible, except to the extent that the donor can demonstrate that the payment exceeds the fair market value of the benefit received from the charity. To facilitate distinguishing charitable contributions from purchases of goods or services from charities, present law provides that no charitable contribution deduction is allowed for a separate contribution of $250 or more unless the donor obtains a contemporaneous written acknowledgement of the contribution from the charity indicating whether the charity provided any good or service (and an estimate of the value of any such good or service) to the taxpayer in consideration for the contribution.[7] In addition, present law requires that any charity that receives a contribution exceeding $75 made partly as a gift and partly as consideration for goods or services furnished by the charity (a "quid pro quo" contribution) is required to inform the contributor in writing of an estimate of the value of the goods or services furnished by the charity and that only the portion exceeding the value of the goods or services is deductible as a charitable contribution.[8]

Under present law, total deductible contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations

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[6] Secs. 170(b) and (e).

[7] Sec. 170(f)(8).

[8] Sec. 6115.

may not exceed 50 percent of the taxpayer's contribution base, which is the taxpayer's adjusted gross income for a taxable year (disregarding any net operating loss carryback). To the extent a taxpayer has not exceeded the 50-percent limitation, (1) contributions of capital gain property to public charities generally may be deducted up to 30 percent of the taxpayer's contribution base, (2) contributions of cash to private foundations and certain other charitable organizations generally may be deducted up to 30 percent of the taxpayer's contribution base, and (3) contributions of capital gain property to private foundations and certain other charitable organizations generally may be deducted up to 20 percent of the taxpayer's contribution base.

Contributions by individuals in excess of the 50-percent, 30-percent, and 20-percent limit may be carried over and deducted over the next five taxable years, subject to the relevant percentage limitations on the deduction in each of those years.

In addition to the percentage limitations imposed specifically on charitable contributions, present law imposes a reduction on most itemized deductions, including charitable contribution deductions, for taxpayers with adjusted gross income in excess of a threshold amount, which is indexed annually for inflation. The threshold amount for 2001 is $132,950 ($66,475 for married individuals filing separate returns). For those deductions that are subject to the limit, the total amount of itemized deductions is reduced by 3 percent of adjusted gross income over the threshold amount, but not by more than 80 percent of itemized deductions subject to the limit. Beginning in 2006, the Economic Growth and Tax Relief Reconciliation Act of 2001 phases-out the overall limitation on itemized deductions for all taxpayers. The overall limitation on itemized deductions is reduced by one-third in taxable years beginning in 2006 and 2007, and by two-thirds in taxable years beginning in 2008 and 2009. The overall limitation on itemized deductions is eliminated for taxable years beginning after December 31, 2009; however this elimination of the limitation sunsets on December 31, 2010.

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity (e.g., a remainder) while also either retaining an interest in that property (e.g., an income interest) or transferring an interest in that property to a noncharity for less than full and adequate consideration.[9] Exceptions to this general rule are provided for, among other interests, remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, and present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property.[10] For such interests, a charitable deduction is allowed to the extent of the present value of the interest designated for a charitable organization.

IRA rules

Within limits, individuals may make deductible and nondeductible contributions to a traditional IRA. Amounts in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal represents a return of nondeductible contributions). Individuals also

[9] Secs. 170(f), 2055(e)(2), and 2522(c)(2).

[10] Sec. 170(f)(2).

may make nondeductible contributions to a Roth IRA. Qualified withdrawals from a Roth IRA are excludable from gross income. Withdrawals from a Roth IRA that are not qualified withdrawals are includible in gross income to the extent attributable to earnings. Includible amounts withdrawn from a traditional IRA or a Roth IRA before attainment of age 59-1/2 are subject to an additional 10-percent early withdrawal tax, unless an exception applies.

If an individual has made nondeductible contributions to a traditional IRA, a portion of each distribution from an IRA is nontaxable, until the total amount of nondeductible contributions has been received. In general, the amount of a distribution that is nontaxable is determined by multiplying the amount of the distribution by the ratio of the remaining nondeductible contributions to the account balance. In making the calculation, all traditional IRAs of an individual are treated as a single IRA, all distributions during any taxable year are treated as a single distribution, and the value of the contract, income on the contract, and investment in the contract are computed as of the close of the calendar year.

In the case of a distribution from a Roth IRA that is not a qualified distribution, in determining the portion of the distribution attributable to earnings, contributions and distributions are deemed to be distributed in the following order: (1) regular Roth IRA contributions; (2) taxable conversion contributions;[11] (3) nontaxable conversion contributions; and (4) earnings. In determining the amount of taxable distributions from a Roth IRA, all Roth IRA distributions in the same taxable year are treated as a single distribution, all regular Roth IRA contributions for a year are treated as a single contribution, and all conversion contributions during the year are treated as a single contribution.

<u>Split-interest trust filing requirements</u>

Split-interest trusts described in section 4947(a)(2), including charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds are required to file an annual information return under section 6034 (Form 1041A). Trusts that are not split-interest trusts but that claim a charitable deduction for amounts permanently set aside for a charitable purpose[12] also are required to file Form 1041A. The returns are required to be made publicly available by section 6104(b). A trust that is required to distribute all trust net income currently to trust beneficiaries in a taxable year is exempt from this return requirement for such taxable year. A trust's failure to file a return required by section 6034 results in a penalty on the trust of $10 a day for as long as the failure continues, up to a maximum of $5,000 per return.

In addition, split-interest trusts are required under section 6011 to file annually Form 5227.[13] Form 5227 requires disclosure of information regarding the trusts' noncharitable beneficiaries. The penalty for failure to file a return under section 6011 is calculated based on the amount of tax owed. A split-interest trust generally is not subject to tax and therefore, in

[11] Conversion contributions refer to conversions of amounts in a traditional IRA to a Roth IRA.

[12] Sec. 642(c).

[13] Treas. Reg. sec. 53.6011-1(d).

general, a penalty may not be imposed for the failure to file Form 5227. Form 5227 is not required to be made publicly available.

Description of Proposal

The proposal would provide an exclusion from gross income for otherwise taxable IRA withdrawals from a traditional or a Roth IRA for qualified charitable distributions. The present-law rules would continue to apply to distributions from an IRA that are not qualified charitable distributions. A qualified charitable distribution would be defined as any distribution from an IRA that is (1) otherwise includible in gross income, (2) made on or after the date the IRA owner attains age 70-1/2, and (3) is made directly by the IRA trustee (a) to a charitable organization to which deductible contributions can be made or (b) to a split-interest entity in which no person holds an income interest in the amounts in the split-interest entity attributable to the charitable distribution other than the IRA owner, his or her spouse, or a charitable organization. A split-interest entity would mean a charitable remainder annuity trust or charitable remainder unitrust, a pooled income fund, or a charitable gift annuity.

The exclusion would apply to distributions made directly to a charitable organization to which deductible contributions can be made only if a charitable contribution deduction for the entire distribution would otherwise be allowable, determined without regard to the percentage limitations. Thus, for example, if the deductible amount would be reduced because of a benefit received in exchange, or if a deduction would not be allowable because the donor did not obtain sufficient substantiation, the exclusion would not be available with respect to any part of the distribution. Similarly, the exclusion would apply in the case of a distribution directly to a split-interest entity only if a charitable contribution deduction for the entire present value of the charitable interest (for example, a remainder interest) would be allowable, determined without regard to the percentage limitations.

In determining the extent to which a distribution is a qualified charitable distribution, the distribution would be treated as consisting of income first, up to the aggregate amount that would be includible in gross income but for the proposal if all amounts were distributed from all IRAs otherwise taken into account in determining the amount includible in income under section 72.

A qualified charitable distribution to a pooled income fund would not be includible in the fund's gross income.

In determining the amount includible in gross income by reason of a payment from a charitable remainder annuity trust or charitable remainder unitrust to which a qualified charitable distribution from an IRA was made, the taxpayer would be required to treat as ordinary income (as described in sec. 664(b)(1)) the total amount distributed directly from the IRA to the trust, except to the extent the taxpayer notifies the trust that a portion of the direct distribution was allocable to investment in the contract. This could occur, for example, if the entire interest in all an individual's traditional IRAs is distributed directly to a charitable remainder trust, and the IRA included nondeductible contributions. Similarly, in determining the amount includible in gross income by reason of a payment from a charitable gift annuity purchased with a qualified charitable distribution from an IRA, the portion of the distribution from the IRA used to purchase the annuity would not be investment in the annuity contract.

Any amount excluded from gross income by reason of the proposal would not be taken into account in determining the deduction for charitable contributions under section 170.

The proposal would increase the penalty on split-interest trusts described in section 4947(a)(2) for failure to file a return and for failure to include any of the information required to be shown on such return and to show the correct information. The penalty would be $20 for each day the failure continues up to $10,000 for any one return. In the case of a split-interest trust with gross income in excess of $250,000, the penalty would be $100 for each day the failure continues up to a maximum of $50,000. If a person (meaning any officer, director, trustee, employee, or other individual who is under a duty to file the return or include required information)[14] knowingly failed to file the return or include required information, then the person would personally be liable for the penalty. Information regarding beneficiaries that are not charitable organizations as described in section 170(c) would be exempt from the requirement to make information publicly available. In addition, the proposal would repeal the present law exception to the filing requirement for split-interest trusts that are required in a taxable year to distribute all net income currently to beneficiaries. Such exception would remain available to nonsplit-interest trusts that are otherwise subject to the filing requirement. It is anticipated that the Secretary of the Treasury would exercise authority under section 6034 to require that Form 5227 be filed pursuant to section 6034.

Effective Date

The proposal generally would be effective for taxable years beginning after December 31, 2001. The provision relating to information returns of split-interest trusts would be effective for returns for taxable years beginning after December 31, 2001.

[14] Sec. 6652(c)(4)(C).

III. INCREASE PERCENTAGE LIMITATION FOR CORPORATE CHARITABLE CONTRIBUTIONS

Present Law

Under present law, a corporation is allowed to deduct charitable contributions up to 10 percent of the corporation's modified taxable income for the year. For this purpose, taxable income is determined without regard to (1) the charitable contributions deduction, (2) any net operating loss carryback, (3) deductions for dividends received, (4) deductions for dividends paid on certain preferred stock of public utilities, and (5) any capital loss carryback for the taxable year.[15] Any charitable contribution by a corporation that is not currently deductible because of the percentage limitation may be carried forward for up to five taxable years.

A transfer of property by a business to a charity might qualify as either a charitable contribution or a deductible business expense, but not both. No deduction is allowed as a business expense under section 162 for any contribution that would be deductible as a charitable gift were it not for the percentage limitations on the charitable contributions deduction.[16] Likewise, a business transfer made with a reasonable expectation of financial return commensurate with the amount of the transfer is not deductible as a charitable contribution, but may be deductible under section 162.

Description of Proposal

The proposal would increase the percentage limitation on corporate charitable deductions from 10 percent to 15 percent. The proposal would be phased-in over nine years, beginning in taxable years beginning after December 31, 2001. The percentage limitation on corporate charitable deductions would be 11 percent in 2002 through 2007, 12 percent in 2008, 13 percent in 2009, and 15 percent in 2010 and thereafter.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 2001.

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[15] Sec. 170(b)(2).

[16] Sec. 162(b).

IV. ENHANCED DEDUCTION FOR CHARITABLE CONTRIBUTIONS OF FOOD INVENTORY

Present Law

Under present law, a taxpayer's deduction for charitable contributions of inventory generally is limited to the taxpayer's basis (typically, cost) in the inventory. However, for certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciated value (i.e., basis plus one half of fair market value in excess of basis) or (2) two times basis.[17]

To be eligible for the enhanced deduction, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in section 501(c) (except for private nonoperating foundations), and the donee must (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements. In the case of contributed property subject to the Federal Food, Drug, and Cosmetic Act, the property must satisfy the applicable requirements of such Act on the date of transfer and for 180 days prior to the transfer.

To use the enhanced deduction, the taxpayer must establish that the fair market value of the donated item exceeds basis. The valuation of food inventory has been the subject of ongoing disputes between taxpayers and the IRS. In one case, the Tax Court held that the value of surplus bread inventory donated to charity was the full retail price of the bread rather than half the retail price, as the IRS asserted.[18]

Description of Proposal

Under the proposal, any taxpayer engaged in a trade or business would be eligible under section 170(e) to claim an enhanced deduction for donations of food inventory. The enhanced deduction would be available only for food that qualifies as "apparently wholesome food." The proposal defines apparently wholesome food as food intended for human consumption that meets all quality and labeling standards imposed by Federal, State, and local laws and regulations even though the food may not be readily marketable due to appearance, age, freshness, grade, size, surplus, or other conditions.

In addition, the proposal would provide that the fair market value of donated apparently wholesome food that cannot or will not be sold solely due to internal standards of the taxpayer or lack of market, would be determined by taking into account the price at which the same or similar food items are sold by the taxpayer at the time of the contribution or, if not so sold at such time, in the recent past.

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[17] Sec. 170(e)(3).

[18] *Lucky Stores Inc. v. Commissioner*, 105 T.C. 420 (1995).

Effective Date

The proposal would be effective for taxable years beginning after December 31, 2001.

V. REFORM EXCISE TAX BASED ON INVESTMENT INCOME OF PRIVATE FOUNDATIONS

Present Law

In general

In general, a private foundation is an organization organized and operated exclusively for charitable purposes.[19] Under section 4940(a) of the Code, private foundations that are recognized as exempt from Federal income tax under section 501(a) of the Code are subject to a two-percent excise tax on their net investment income. Private foundations that are not exempt from tax, such as certain charitable trusts,[20] also are subject to an excise tax under section 4940(b).

Net investment income is determined under the principles of Subtitle A of the Code, except to the extent those principles are inconsistent with section 4940. Net investment income is defined as the amount by which the sum of gross investment income and capital gain net income exceeds the deductions relating to the production of gross investment income.[21] Net investment income also is determined by applying section 103 (generally providing an exclusion for interest on certain State and local bonds) and section 265 (generally disallowing the deduction for interest and certain other expenses with respect to tax-exempt income).[22] Special definitions of gross investment income and capital gain net income are provided for purposes of the excise tax.[23]

The two-percent rate of tax is reduced to one-percent if certain requirements are met in a taxable year.[24] The requirements are that the foundation's qualifying distributions (generally, amounts paid to accomplish exempt purposes)[25] must be at least a certain amount and the foundation cannot have been subject to tax for failure to distribute a certain amount of income[26] for any of the five years preceding the taxable year (the "base period"). The required amount of qualifying distributions is the sum of two elements: (1) the amount of the foundation's assets for the taxable year multiplied by the average over the base period of the percentage of assets

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[19] Secs. 509(a) and 501(c)(3).

[20] Sec. 4947.

[21] Sec. 4940(c)(1).

[22] Sec. 4940(c)(5).

[23] Secs. 4940(c)(2) and 4940(c)(4).

[24] Sec. 4940(e).

[25] Sec. 4942(g).

[26] Sec. 4942.

distributed as qualifying distributions in a year divided by the assets of the foundation for the year (the "average percentage payout for the base period") plus (2) one percent of the net investment income of the foundation for the taxable year.[27]

The tax on taxable private foundations under section 4940(b) 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 unrelated business income tax 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 (taxable and tax exempt) are required to pay estimated taxes of the section 4940 tax in quarterly installments in the same manner as corporate estimated tax payments.[28] "Exempt operating foundations" are exempt from the section 4940 tax.[29]

The amount of tax paid under section 4940 reduces a foundation's "distributable amount" under section 4942.[30] Accordingly, the minimum amount of qualified distributions a foundation has to make to avoid tax under section 4942 is reduced by the amount of section 4940 excise taxes paid.

Description of Proposal

The proposal would replace the two rates of tax under present law with a single rate of tax based on net investment income and would set such rate of tax at one percent. Thus, a tax-exempt private foundation would be subject to tax on one percent of net investment income and would not have to calculate its average percentage payout for the base period to determine eligibility for a different rate of tax. A taxable private foundation would be subject to tax on the excess of the sum of one percent of net investment income and the amount of the unrelated business income tax (both calculated as if the foundation were tax-exempt) over the income tax imposed on the foundation under subtitle A of the Code.

[27] Sec. 4940(e).

[28] Treas. Reg. sec. 1.6302-1.

[29] Sec. 4940(d)(1). 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. Sec. 4940(d)(2). 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. For an organization to qualify as an exempt operating foundation it must obtain a ruling letter from the IRS. IRS Announcement 85-88.

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

Effective Date

The proposal would be effective for taxable years beginning after December 31, 2001.

VI. MODIFY TAX ON UNRELATED BUSINESS TAXABLE INCOME OF CHARITABLE REMAINDER TRUSTS

Present Law

Sections 170(f), 2055(e)(2), and 2522(c)(2) disallow a charitable deduction for income, estate or gift tax purposes, respectively, if the donor transfers an interest in property to a charity (e.g., a remainder interest) while also either retaining an interest in that property (e.g., an income interest) or transferring an interest in that property to a noncharity for less than full and adequate consideration. One of several exceptions to this general rule is provided for remainder interests in charitable remainder annuity trusts and charitable remainder unitrusts.

A charitable remainder annuity trust is a trust that is required to pay, at least annually, a fixed dollar amount of at least five percent of the initial value of the trust to a noncharity for the life of an individual or for a period of less than 20 years, with the remainder passing to charity. A charitable remainder unitrust is a trust that generally is required to pay, at least annually, a fixed percentage of at least five percent of the fair market value of the trust's assets determined at least annually to a non-charity for the life of an individual or for a period less than 20 years, with the remainder passing to charity.[31]

A trust does not qualify as charitable remainder annuity trust if the annuity for a year is greater than 50 percent of the initial fair market value of the trust's assets. A trust does not qualify as a charitable remainder unitrust if the percentage of assets that are required to be distributed at least annually is greater than 50 percent. A trust does not qualify as a charitable remainder annuity trust or a charitable remainder unitrust unless the value of the remainder interest in the trust is at least 10 percent of the value of the assets contributed to the trust.

Distributions from a charitable remainder annuity trust or charitable remainder unitrust are treated in the following order as: (1) ordinary income to the extent of the trust's current and previously undistributed ordinary income for the trust's year in which the distribution occurred, (2) capital gains to the extent of the trust's current capital gain and previously undistributed capital gain for the trust's year in which the distribution occurred, (3) other income (e.g., tax-exempt income) to the extent of the trust's current and previously undistributed other income for the trust's year in which the distribution occurred, and (4) corpus.[32]

Distributions are includible in the income of the beneficiary for the year that the annuity or unitrust amount is required to be distributed even though the annuity or unitrust amount is not distributed until after the close of the trust's taxable year.[33]

Under section 664(c), charitable remainder annuity trusts and charitable remainder unitrusts are exempt from Federal income tax unless the trust has any unrelated business taxable

[31] Sec. 664(d).

[32] Sec. 664(b).

[33] Treas. Reg. sec. 1.664-1(d)(4).

income. Under section 514, unrelated business taxable income includes certain debt financed income.

Description of Proposal

In lieu of removing the income tax exemption of a charitable remainder trust for any year in which the trust has any unrelated business taxable income, the proposal would impose a 100 percent excise tax on the unrelated business taxable income of the trust. Because the effect of the excise tax would be the same as if the unrelated business taxable income had not been incurred by the charitable remainder annuity trust or charitable remainder unitrust, the provision would exclude such income from the determination of (1) the value of a charitable remainder unitrust's assets,[34] (2) the amount of charitable remainder unitrust income for purposes of determining the unitrust's required distributions, and (3) the effect on the income character of any distributions to beneficiaries by a charitable remainder annuity trust or charitable remainder unitrust.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 2001, regardless of when the trust was created.

[34] *See* Treas. Reg. sec. 1.664-3(a)(iv), which requires that all assets and liabilities of the trust are taken into account in determining their net fair market value.

VII. EXTEND "CONSTRUCTED BY" REQUIREMENT FOR CONTRIBUTIONS OF SCIENTIFIC PROPERTY USED FOR RESEARCH AND FOR COMPUTER TECHNOLOGY AND EQUIPMENT

Present Law

In the case of a charitable contribution of inventory or other ordinary-income or short-term capital gain property, the amount of the deduction is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose. In cases involving contributions to a private foundation (other than certain private operating foundations), the amount of the deduction is limited to the taxpayer's basis in the property.[35]

Under present law, a taxpayer's deduction for charitable contributions of scientific property used for research and for contributions of computer technology and equipment generally is limited to the taxpayer's basis (typically, cost) in the property. However, certain corporations may claim a deduction in excess of basis for a "qualified research contribution" or a "qualified computer contribution."[36] This enhanced deduction is equal to the lesser of (1) basis plus one-half of the item's appreciated value (i.e., basis plus one half of fair market value minus basis) or (2) two times basis.

A qualified research contribution means a charitable contribution of inventory that is tangible personal property. The contribution must be to a qualified educational or scientific organization and be made not later than two years after construction of the property is substantially completed. The original use of the property must be by the donee, and be used substantially for research or experimentation, or for research training in the U.S. in the physical or biological sciences. The property must be scientific equipment or apparatus, constructed by the taxpayer, and may not be transferred by the donee in exchange for money, other property, or services. The donee must provide the taxpayer with a written statement representing that it will use the property in accordance with the conditions for the deduction. For purposes of the enhanced deduction, property is considered constructed by the taxpayer only if the cost of the parts used in the construction of the property (other than parts manufactured by the taxpayer or a related person) do not exceed 50 percent of the taxpayer's basis in the property.

A qualified computer contribution means a charitable contribution of any computer technology or equipment, which meets standards of functionality and suitability as established by the Secretary of the Treasury. The contribution must be to certain educational organizations or public libraries and made not later than three years after the taxpayer acquired the property or, if the taxpayer constructed the property, not later than the date construction of the property is

[35] Sec. 170(e)(1).

[36] Secs. 170(e)(4) and 170(e)(6).

substantially completed.[37] The original use of the property must be by the donor or the donee,[38] and in the case of the donee, must be used substantially for educational purposes related to the function or purpose of the donee. The property must fit productively into the donee's education plan. The donee may not transfer the property in exchange for money, other property, or services, except for shipping, installation, and transfer costs. To determine whether property is constructed by the taxpayer, the rules applicable to qualified research contributions apply. Contributions may be made to private foundations under certain conditions.[39]

Description of Proposal

Under the proposal, property assembled by the taxpayer, in addition to property constructed by the taxpayer, would be eligible for either enhanced deduction.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 2001.

[37] If the taxpayer constructed the property and reacquired such property, the contribution must be within three years of the date the original construction was substantially completed. Sec. 170(e)(6)(D)(i).

[38] This requirement does not apply if the property was reacquired by the manufacturer and contributed. Sec. 170(e)(6)(D)(ii).

[39] Sec. 170(e)(6)(C).

VIII. BASIS ADJUSTMENT TO STOCK OF S CORPORATION CONTRIBUTING APPRECIATED PROPERTY

Present Law

Under present law, if an S corporation contributes money or other property to a charity, each shareholder takes into account the shareholder's pro rata share of the contribution in determining its own income tax liability.[40] A shareholder of an S corporation must reduce the basis in the stock of the S corporation by the amount of the contribution that flows through to the shareholder.[41]

Description of Proposal

The proposal would allow a shareholder in an S corporation to increase the basis of the S corporation stock by an amount equal to the excess of the charitable contribution deduction that flows through to the shareholder over the shareholder's pro rata share of the adjusted basis of the property contributed.

Effective Date

The proposal would apply to taxable years beginning after December 31, 2001.

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[40] Sec. 1366(a)(1)(A).

[41] Sec. 1367(a)(2)(B).

IX. INDIVIDUAL DEVELOPMENT ACCOUNTS

Present Law

The Assets for Independence Act[42] authorizes $25 million annually for a five-year demonstration Individual Development Account ("IDA") program to evaluate the effects of savings incentives on persons of limited means. Means tested programs must disregard all funds in an IDA, including accruing interest, in determining an individual's eligibility. The demonstration program provides direct Federal funds to nonprofit organizations, States and localities, tribal governments, community-development financial institutions, and certain credit unions to match the amount of earnings deposited by eligible individuals. Grantees must provide nonFederal matching funds (one dollar per Federal grant dollar), and the maximum Federal grant is $1 million for each project year. Eligible persons are those (1) who are eligible under the Temporary Assistance for Needy Families program, or (2) whose household net worth is below $10,000 ("net worth test"), and who meet the greater of (a) the income limits of the earned income credit (taking into account the size of the household)[43] or (b) 200 percent of the poverty guideline ("income test").

Each participant is eligible to receive up to $2,000 in Federal funds and an equal amount from project matching funds (at an agreed-upon match rate) plus accrued interest while they participate over the course of the project. Households may receive no more than $4,000 in Federal grant funds over the course of the project. The projects must create trust or custodial accounts that permit withdrawals of account balances only for three designated purposes: (1) first home purchase, (2) business capitalization, and (3) postsecondary education. Emergency withdrawals (from the account holder's own deposits only) are allowed for three conditions -- medical expenses, prevention of eviction or mortgage foreclosure, and living expenses after job losses.

Each grantee is required to prepare an annual report on the progress of its project. These reports must be submitted to the Secretary of Health and Human Services, and if a tribe, State or local government committed funds to the project, to the Treasurer (or equivalent official) of the State in which the project is conducted. The Secretary of Health and Human Services is required to provide the results of these reports to Congress every 12 months until all of the demonstration projects are completed, and to submit a final report, setting forth the results and findings of all reports and evaluations, not later than 12 months after the conclusion of all demonstration projects. The Assets for Independence Act directs the Secretary of Health and Human Services to enter into a contract with an independent research organization to evaluate the projects, individually, and as a group. The Secretary of Health and Human Services may spend up to $500,000 each fiscal year for evaluation expenses.

The demonstration program expires at the end of fiscal year 2003.

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[42] Title IV of Pub. L. No. 105-285 (1998).

[43] Sec. 32(b)(2).

Description of Proposal

The proposal would eliminate references to "demonstration" projects. The proposal would expand the category of qualified entities that could apply for IDA projects to include any federally-insured credit union.

The proposal would repeal the current household cap on receipt of Federal funds. The individual lifetime cap on receipt of Federal funds would be replaced with an annual cap of $500.

The proposal would increase the net worth test for eligible individuals from $10,000 to $20,000.

The proposal would extend the program for an additional five years, through fiscal year 2008. Under the proposal, the annual program authorization would be doubled from $25 million to $50 million, beginning in fiscal year 2002.

The program modifications made under the proposal and the "Assets for Independence Act Amendments of 2000"[44] would apply to existing grants, as well as grants made on or after the date of enactment.

Effective Date

The proposal would be effective on the date of enactment.

[44] Title IV of H.R. 5656 as enacted by Pub. L. No. 106-554 (2000). The "Assets for Independence Act Amendments of 2000" (1) made matching contributions unavailable for emergency withdrawals, (2) added low income credit unions and community financial development institutions as qualified entities; (3) modified home purchase costs; (4) increased set-aside for economic literacy training and administrative costs; (5) added the 200 percent of poverty alternative to the income test; (6) revised the annual and interim progress report deadlines; (7) increased appropriations for evaluation expenses; and (8) provided that means tested programs must disregard all funds in an IDA, including accruing interest, in determining an individual's eligibility. *Id*. at secs. 602-610.