DESCRIPTION OF THE CHAIRMAN'S MODIFICATION TO THE PROVISIONS OF THE "TAX RELIEF ACT OF 2005"

Scheduled for Markup
By the
SENATE COMMITTEE ON FINANCE
on November 15, 2005

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the Chairman's modification to the provisions of the "Tax Relief Act of 2005," which is scheduled to be marked up by the Senate Committee on Finance on November 15, 2005.

[1] This document may be cited as follows: Joint Committee on Taxation, *Description of the Chairman's Modification to the Provisions of the "Tax Relief Act of 2005,"* (JCX-77-05), November 14, 2005.

A. Modifications to Provisions in the Chairman's Mark[2]

1. Modification to low income housing credit (item I.A.6)[3]

Under the modification to the Chairman's mark dealing with the low income housing credit, the Gulf Opportunity Zone is treated as a high-cost area for purposes of the low income housing credit for property placed-in-service in calendar years 2006, 2007, 2008 and 2009. Therefore, buildings located in the Gulf Opportunity Zone are eligible for the enhanced credit. Under the enhanced credit, the 70-percent and 30-percent credits are increased to 91-percent and 39-percent credits, respectively. The 20-percent of population restriction is waived for this purpose. This enhanced credit applies regardless of whether the building receives its credit allocation under the otherwise applicable low-income housing credit cap or the additional credit cap.

2. Modifications to increased expensing for reforestation expenditures of small timber producers (item I.A.12)

The modification eliminates the aggregation provisions of the Chairman's mark, which apply for purposes of determining whether a taxpayer's aggregate holdings of qualified timber property exceed 500 acres at any time during the taxable year. The modification also amends the "large timber producer" test to exclude from the increased expensing limit those taxpayers who held in excess of 500 acres as of August 28, 2005 (in the case of qualified timber property any portion of which is located in the Gulf Opportunity Zone), September 23, 2005 (in the case of qualified timber property any portion of which is located in the Rita Zone and no portion of which is located in the Gulf Opportunity Zone), or October 23, 2005 (in the case of qualified timber property any portion of which is located in the Wilma Zone). Finally, the modification excludes public corporations and Real Estate Investment Trusts ("REITs") from eligibility for the increased reforestation expensing limit.

3. Modifications to five-year NOL carryback of certain timber losses (item I.A.13)

The modification eliminates the aggregation provisions of the Chairman's mark, which apply for purposes of determining whether a taxpayer's aggregate holdings of qualified timber property exceed 500 acres as of August 28, 2005 (in the case of qualified timber property any portion of which is located in the Gulf Opportunity Zone), September 23, 2005 (in the case of qualified timber property any portion of which is located in the Rita Zone and no portion of which is located in the Gulf Opportunity Zone), or October 23, 2005 (in the case of qualified timber property any portion of which is located in the Wilma Zone). The modification also excludes public corporations and REITs from taking into account income and loss attributable to

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[2] For a description of the Chairman's mark, see Joint Committee on Taxation, *Description of the Chairman's Mark of the "Tax Relief Act of 2005"* (JCX-71-05), November 8, 2005.

[3] Item numbers refer to provisions in the Chairman's mark.

qualified timber property for purposes of computing the amount of farming loss eligible for a five-year NOL carryback.

4. Modification to AMT exemption amounts (item III.B.2)

Under the Chairman's modification, the individual alternative minimum tax exemption amounts for 2006 are adjusted for inflation.

5. Deletion of provision relating to the special look-back rule for determining earned income credits and refundable child credits (item II.F)

The Chairman's modification deletes the proposal relating to the special look-back rule for determining earned income credits and refundable child credits contained in item II.F.

6. Deletion of provision relating to Secretarial authority to make certain adjustments regarding taxpayer dependency status (item II.G)

The Chairman's modification deletes the proposal relating to the Secretarial authority to make adjustments regarding taxpayer dependency status for taxpayers affected by Hurricane Rita and Hurricane Wilma contained in item II.G.

7. Deletion of extension of reduced rates on dividends and capital gains (item III.A.1)

Under the modification, the extension of reduced rates on dividends and long-term capital gains through 2009 is deleted from the Chairman's mark.

8. Modification relating to the research credit (item III.B.4)

The modified proposal eliminates the rule in the Chairman's mark requiring that research credit amounts earned in 2006 not be taken into account in computing estimated tax payments required to be paid for taxable years beginning in 2006.

The modified proposal increases the rates of the alternative incremental credit: (1) a credit rate of three percent (rather than 2.65 percent) applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of one percent (i.e., the base amount equals one percent of the taxpayer's average gross receipts for the four preceding years) but do not exceed a base amount computed by using a fixed-base percentage of 1.5 percent; (2) a credit rate of four percent (rather than 3.2 percent) applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1.5 percent but do not exceed a base amount computed by using a fixed-base percentage of two percent; (3) a credit rate of five percent (rather than 3.75 percent) applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of two percent.

The modified proposal also creates, at the election of the taxpayer, an alternative simplified credit for qualified research expenses. The alternative simplified research is equal to 12 percent of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding taxable years. The rate is reduced to 6 percent if a taxpayer has no qualified research expenses in any one or more of the three preceding taxable years.

An election to use the alternative simplified credit applies to all succeeding taxable years unless revoked with the consent of the Secretary. An election to use the alternative simplified credit may not be made for any taxable year for which an election to use the alternative incremental credit is in effect. A special transition rule applies which permits a taxpayer to elect to use the alternative simplified credit in lieu of the alternative incremental credit if such election is made during the taxable year which includes the date of enactment of the modified proposal. The transition rule only applies to the taxable year which includes the date of enactment.

The modified proposal also expands the definition of "funded research" ineligible for the research credit. In general, under the modified proposal, all payments pursuant to any government contract are treated as funding research and are therefore ineligible for the research credit. Payments received pursuant to a subcontracting agreement or similar contract are also considered government funded to the extent they would be government funded under the prime contract.

Two exceptions apply with respect to government funded research. Under the first exception, government contracts having no new and significant performance specifications are not treated as funding research under the modified proposal, except where the contractor does not retain substantial rights to the research. For purposes of this exception, contracts under the modified proposal are not treated as having new and significant performance specifications where the contractor reasonably expects that not more than ten percent of the total costs of performing under the contract will be allocable to qualified research. In determining whether more than ten percent of total costs are allocable to qualified research, all research costs under a contract (including costs reasonably expected to be incurred by subcontractors and independent contractors) are considered. For purposes of this exception, options under a contract that may be exercised at the discretion of the government are treated as separate contracts. Under the second exception, qualified research undertaken by a government contractor is not to be treated as funded research unless the research is required to meet the contract's performance specifications.

The modified proposal applies to taxable years ending after December 31, 2005.

9. Deletion of provision relating to parity in the application of certain limits to mental health benefits (item III.B.5)

The modification strikes the provision in the Chairman's mark relating to parity in the application of certain limits to mental health benefits.

10. Deletion of extension of rum excise tax cover over (item III.B.8)

The modification strikes the provision in the Chairman's mark that extends the present-law limitation on the rate of rum excise tax cover over to Puerto Rico and the Virgin Islands.

11. Modifications to extension of expensing for environmental remediation costs (item III.B.11)

The modification provides that petroleum products are treated as hazardous substances for purposes of applying the brownfields expensing provision (as extended).[4] Petroleum products are defined by reference to section 4612(a)(3), and include crude oil, crude oil condensates and natural gasoline.[5] Thus, for example, the release of crude oil upon property held for use in a trade or business results in such property being treated as a qualified contaminated site. Expenditures paid or incurred to abate the contamination on or after December 31, 2005 and before December 31, 2006, would be eligible for expensing.[6]

12. Deletion of provision relating to prohibition on deferral of certain stock option and restricted stock gains (item IV.F.5)

The modification strikes the provision of the Chairman's mark relating to prohibition on deferral of certain stock option and restricted stock gains.

13. Deletion of provision related to elimination of double deduction of mining exploration and development cost under the minimum tax (item IV.F.7)

Under the modification, the provision related to elimination of double deduction of mining exploration and development cost under the minimum tax is deleted from the Chairman's mark.

14. Deletion of provision related to the holding period requirement for reduced tax rate on dividends on preferred stock (item IV.F.9)

Under the modification, the provision related to the holding period requirement for the reduced tax rate on dividends on preferred stock is deleted from the Chairman's mark.

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[4] The proposal applies to expenditures paid or incurred after December 31, 2005.

[5] The present law exceptions for sites on the national priorities list under CERCLA, and for substances with respect to which a removal or remediation is not permitted under section 104 of CERCLA by reason of subsection (a)(3) thereof, would continue to apply to all hazardous substances (including petroleum products).

[6] Note that under item I.A.15 of the Chairman's mark, petroleum products are treated as hazardous substances, effective for expenditures paid or incurred after August 28, 2005, and before December 31, 2007, to abate contamination in the Gulf Opportunity Zone.

B. Additional Provisions

1. Charitable deduction for nonitemizers; floor on deductions for itemizers

Present Law

In computing taxable income, an individual taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and up to the fair market value of property contributed to a charity described in section 501(c)(3),[7] to certain veterans' organizations, fraternal societies, and cemetery companies,[8] or to a Federal, State, or local governmental entity for exclusively public purposes.[9] 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.[10]

A taxpayer who takes the standard deduction (i.e., who does not itemize deductions) may not take a separate deduction for charitable contributions.[11]

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.[12] 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

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[7] All section references are to the Internal Revenue Code of 1986, unless otherwise indicated.

[8] Secs. 170(c)(3)-(5).

[9] Sec. 170(c)(1).

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

[11] 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 for contributions made after 1986.

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

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.[13]

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 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 2005 is $145,950 ($72,975 for married individuals filing separate returns). For those deductions that are subject to the limit, the total amount of itemized deductions is reduced by three 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 overall limitation on itemized deductions phases-out 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 allows a deduction for nonitemizers from adjusted gross income for charitable contributions paid in cash during the taxable year. This deduction is allowed in addition to the standard deduction. The deduction is available only for that portion of contributions made during the year that in the aggregate exceed $250 ($500 in the case of a joint return). Contributions that are below the minimum amount may not be carried over for purposes of a subsequent taxable year's calculation of the deduction.

[13] Sec. 6115.

The proposal does not otherwise alter present-law rules regarding the carryover of contributions to or from a taxable year, including a taxable year in which the taxpayer elects the standard deduction. The deduction for nonitemizers generally is subject to the tax rules normally governing charitable contribution deductions, such as the substantiation requirements. The deduction is allowed in computing alternative minimum taxable income.

Under the proposal, an individual taxpayer who itemizes deductions is subject to a floor on all charitable contributions, cash and noncash, of $250 ($500 in the case of a joint return). Accordingly, the first $250 ($500 in case of a joint return) of charitable contributions of such taxpayer (whether as carryovers of excess contributions or otherwise) for each taxable year are not allowed. The proposal does not otherwise change the present-law rules pertaining to charitable contributions.

Effective Date

The proposal is effective for contributions made in taxable years beginning after December 31, 2005, and before January 1, 2008.

2. 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 to the amount withdrawn and the charitable contribution is subject to the normally applicable limitations on deductibility of such contributions.

Charitable contributions

In computing taxable income, an individual taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and up to the fair market value of property contributed to a charity described in section 501(c)(3), to certain veterans' organizations, fraternal societies, and cemetery companies,[14] or to a Federal, State, or local governmental entity for exclusively public purposes.[15] The deduction also is allowed for purposes of calculating alternative minimum taxable income.

[14] Secs. 170(c)(3)-(5).

[15] Sec. 170(c)(1).

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.[16]

A taxpayer who takes the standard deduction (i.e., who does not itemize deductions) may not take a separate deduction for charitable contributions.[17]

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, among other things, 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.[18] 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 may be deductible as a charitable contribution.[19]

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 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 limits 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.

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

[17] Sec. 170(a).

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

[19] Sec. 6115.

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 2005 is $145,950 ($72,975 for married individuals filing separate returns). For those deductions that are subject to the limit, the total amount of itemized deductions is reduced by three 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 overall limitation on itemized deductions phases-out 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.[20] 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.[21] 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 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

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

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

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;[22] (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.

Split-interest trust filing requirements

Split-interest trusts, including charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, are required to file an annual information return[23] (Form 1041A). Trusts that are not split-interest trusts but that claim a charitable deduction for amounts permanently set aside for a charitable purpose[24] also are required to file Form 1041A. The returns are required to be made publicly available.[25] 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 failure to file the required return may result 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 to file annually Form 5227.[26] Form 5227 requires disclosure of information regarding a trust's noncharitable beneficiaries. The penalty for failure to file this return is calculated based on the amount of tax owed. A split-interest trust generally is not subject to tax and therefore, in 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

Qualified charitable distributions from IRAs

The provision provides an exclusion from gross income for otherwise taxable IRA distributions from a traditional or a Roth IRA in the case of qualified charitable distributions.[27]

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

[23] Sec. 6034. This requirement applies to all split-interest trusts described in section 4947(a)(2).

[24] Sec. 642(c).

[25] Sec. 6104(b).

[26] Sec. 6011; Treas. Reg. sec. 53.6011-1(d).

[27] The proposal does not apply to distributions from employer sponsored retirements plans, including SIMPLE IRAs and simplified employee pensions ("SEP").

Special rules apply in determining the amount of an IRA distribution that is otherwise taxable. The present-law rules regarding taxation of IRA distributions and the deduction of charitable contributions continue to apply to distributions from an IRA that are not qualified charitable distributions. Qualified charitable distributions are taken into account for purposes of the minimum distribution rules applicable to IRAs to the same extent the distribution would have been taken into account under such rules had the distribution not been directly distributed under the provision. An IRA does not fail to qualify as an IRA merely because qualified charitable distributions have been made from the IRA. It is intended that the Secretary will prescribe rules under which IRA owners are deemed to elect out of withholding if they designate that a distribution is intended to be a qualified charitable distribution.

A qualified charitable distribution is defined as any distribution from an IRA that is made after December 31, 2005, and before January 1, 2008, directly by the IRA trustee either to (1) an organization to which deductible contributions can be made (a "direct distribution") or (2) a "split-interest entity." A split-interest entity means a charitable remainder annuity trust or charitable remainder unitrust (together referred to as a "charitable remainder trust"), a pooled income fund, or a charitable gift annuity. Direct distributions are eligible for the exclusion only if made on or after the date the IRA owner attains age 70-1/2. Distributions to a split interest entity are eligible for the exclusion only if made on or after the date the IRA owner attains age 59-1/2. In the case of split-interest distributions, no person may hold an income interest in the amounts in the split-interest entity attributable to the charitable distribution other than the IRA owner, the IRA owner's spouse, or a charitable organization.

The exclusion applies to direct distributions only if a charitable contribution deduction for the entire distribution otherwise would be allowable (under present law), determined without regard to the generally applicable percentage limitations. Thus, for example, if the deductible amount is reduced because of a benefit received in exchange, or if a deduction is not allowable because the donor did not obtain sufficient substantiation, the exclusion is not available with respect to any part of the IRA distribution. Similarly, the exclusion applies 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) otherwise would be allowable, determined without regard to the generally applicable percentage limitations.

If the IRA owner has any IRA that includes nondeductible contributions, a special rule applies in determining the portion of a distribution that is includible in gross income (but for the provision) and thus is eligible for qualified charitable distribution treatment. Under the special rule, the distribution is treated as consisting of income first, up to the aggregate amount that would be includible in gross income (but for the provision) if the aggregate balance of all IRAs having the same owners were distributed during the same year. In determining the amount of subsequent IRA distributions includible in income, proper adjustments are made to reflect the amount treated as a qualified charitable distribution under the special rule.

Special rules apply for distributions to split-interest entities. For distributions to charitable remainder trusts, the provision provides that subsequent distributions from the charitable remainder trust are treated as ordinary income in the hands of the beneficiary, notwithstanding how such amounts normally are treated under section 664(b).[28] In addition, for a charitable remainder trust to be eligible to receive qualified charitable distributions, the charitable remainder trust has to be funded exclusively by such distributions. For example, an IRA owner may not make qualified charitable distributions to an existing charitable remainder trust any part of which was funded with assets that were not qualified charitable distributions.

Under the provision, a pooled income fund is eligible to receive qualified charitable distributions only if the fund accounts separately for amounts attributable to such distributions. In addition, all distributions from the pooled income fund that are attributable to qualified charitable distributions are treated as ordinary income to the beneficiary. Qualified charitable distributions to a pooled income fund are not includible in the fund's gross income.

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 is not an investment in the annuity contract.

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

Qualified charitable distribution examples

The following examples illustrate the determination of the portion of an IRA distribution that is a qualified charitable distribution and the application of the special rules for a qualified charitable distribution to a split-interest entity. In each example, it is assumed that the requirements for qualified charitable distribution treatment are otherwise met (e.g., the applicable age requirement and the requirement that contributions are otherwise deductible) and that no other IRA distributions occur during the year.

Example 1.−Individual A has a traditional IRA with a balance of $100,000, consisting solely of deductible contributions and earnings. Individual A has no other IRA. The entire IRA balance is distributed in a direct distribution to a charitable organization. Under present law, the entire distribution of $100,000 would be includible in Individual A's income. Accordingly, under the provision, the entire distribution of $100,000 is a qualified charitable distribution. As a result, no amount is included in Individual A's income as a result of the distribution and the distribution is not taken into account in determining the amount of Individual A's charitable deduction for the year.

Example 2.−The facts are the same as in Example 1, except that the entire IRA balance of $100,000 is distributed to a charitable remainder unitrust, which contains no other assets and which must be funded exclusively by qualified charitable distributions. Under the terms of the trust, Individual A is entitled to receive five percent of the net fair market value of the trust assets

[28] Although qualified charitable distributions by definition must be made after August 28, 2005, and before January 1, 2006, the rules of the provision (including rules relating to later distributions from an IRA or a split-interest entity) are effective with respect to and after such time period.

each year. As explained in Example l, the entire $100,000 distribution is a qualified charitable distribution, no amount is included in Individual A's income as a result of the distribution, and the distribution is not taken into account in determining the amount of Individual A's charitable deduction for the year. In addition, under a special rule in the provision for charitable remainder trusts, any distribution from the charitable remainder unitrust to Individual A is includible in gross income as ordinary income, regardless of the character of the distribution under the usual rules for the taxation of distributions from such a trust.

Example 3.−Individual B has a traditional IRA with a balance of $100,000, consisting of $20,000 of nondeductible contributions and $80,000 of deductible contributions and earnings. Individual B has no other IRA. In a direct distribution to a charitable organization, $80,000 is distributed from the IRA. Under present law, a portion of the distribution from the IRA would be treated as a nontaxable return of nondeductible contributions. The nontaxable portion of the distribution would be $16,000, determined by multiplying the amount of the distribution ($80,000) by the ratio of the nondeductible contributions to the account balance ($20,000/$100,000). Accordingly, under present law, $64,000 of the distribution ($80,000 minus $16,000) would be includible in Individual B's income.

Under the provision, notwithstanding the present-law tax treatment of IRA distributions, the distribution is treated as consisting of income first, up to the total amount that would be includible in gross income (but for the provision) if all amounts were distributed from all IRAs otherwise taken into account in determining the amount of IRA distributions. The total amount that would be includible in income if all amounts were distributed from the IRA is $80,000. Accordingly, under the provision, the entire $80,000 distributed to the charitable organization is treated as includible in income (before application of the provision) and is a qualified charitable distribution. As a result, no amount is included in Individual B's income as a result of the distribution and the distribution is not taken into account in determining the amount of Individual B's charitable deduction for the year. In addition, for purposes of determining the tax treatment of other distributions from the IRA, $20,000 of the amount remaining in the IRA is treated as Individual B's nondeductible contributions (i.e., not subject to tax upon distribution).

Split-interest trust filing requirements

The provision increases the penalty on split-interest trusts 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 is $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 is $100 for each day the failure continues up to a maximum of $50,000. In addition, 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)[29] knowingly failed to file the return or include required information, then that person is personally liable for such a penalty, which would be imposed in addition to the penalty that is paid by the organization. Information regarding beneficiaries that are not charitable organizations as described in section 170(c) is exempt from

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

the requirement to make information publicly available. In addition, the provision repeals 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 remains available to trusts other than split-interest trusts that are otherwise subject to the filing requirement.

Effective Date

The provision relating to qualified charitable distributions is effective for distributions made in taxable years beginning after December 31, 2005, and before January 1, 2008. The provision relating to information returns of split-interest trusts is effective for returns for taxable years beginning after December 31, 2005.

3. Charitable deduction for 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, or if less the fair market value of the inventory.

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 appreciation (i.e., basis plus one half of fair market value in excess of basis) or (2) two times basis (sec. 170(e)(3)). In general, a C corporation's charitable contribution deductions for a year may not exceed 10 percent of the corporation's taxable income (sec. 170(b)(2)). 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)(3) (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.

A donor making a charitable contribution of inventory must make a corresponding adjustment to the cost of goods sold by decreasing the cost of goods sold by the lesser of the fair market value of the property or the donor's basis with respect to the inventory (Treas. Reg. sec. 1.170A-4A(c)(3)). Accordingly, if the allowable charitable deduction for inventory is the fair market value of the inventory, the donor reduces its cost of goods sold by such value, with the result that the difference between the fair market value and the donor's basis may still be recovered by the donor other than as a charitable contribution.

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 disputes between taxpayers and the IRS.[30]

Description of Proposal

Under the proposal, any taxpayer, whether or not a C corporation, engaged in a trade or business is eligible to claim the enhanced deduction for donations of food inventory. For taxpayers other than C corporations, the total deduction for donations of food inventory in a taxable year generally may not exceed 10 percent of the taxpayer's net income for such taxable year from all sole proprietorships, S corporations, or partnerships (or other non C corporation) from which contributions of apparently wholesome food are made. For example, if a taxpayer is a sole proprietor, a shareholder in an S corporation, and a partner in a partnership, and each business makes charitable contributions of food inventory, the taxpayer's deduction for donations of food inventory is limited to 10 percent of the taxpayer's net income from the sole proprietorship and the taxpayer's interests in the S corporation and partnership. However, if only the sole proprietorship and the S corporation made charitable contributions of food inventory, the taxpayer's deduction would be limited to 10 percent of the net income from the trade or business of the sole proprietorship and the taxpayer's interest in the S corporation, but not the taxpayer's interest in the partnership.

The 10 percent limitation does not affect the application of the generally applicable percentage limitations. For example, if 10 percent of a sole proprietor's net income from the proprietor's trade or business was greater than 50 percent of the proprietor's contribution base, the available deduction for the taxable year (with respect to contributions to public charities) would be 50 percent of the proprietor's contribution base. Consistent with present law, such contributions may be carried forward because they exceed the 50 percent limitation. Contributions of food inventory by a taxpayer that is not a C corporation that exceed the 10 percent limitation but not the 50 percent limitation could not be carried forward.

For purposes of calculating the enhanced deduction, taxpayers who do not account for inventories under section 471 and who are not required to capitalize indirect costs under section 263A are able to elect to treat the basis of the contributed food as being equal to 25 percent of the food's fair market value.[31]

The proposal changes the amount of the present-law enhanced deduction for eligible contributions of food inventory to the lesser of fair market value or twice the taxpayer's basis in the inventory. For example, a taxpayer who makes an eligible donation of food that has a fair market value of $10 and a basis of $4 could take a deduction of $8 (twice basis). If the

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

[31] This includes, for example, taxpayers who are eligible for administrative relief under Revenue Procedures 2002-28 and 2001-10.

taxpayer's basis was $6 instead of $4, then the deduction would be $10 (fair market value). By contrast, under present law, a C corporation's deduction in the first example would be $7 (fair market value less half the appreciation) and in the second example would be $8. (Under present law, taxpayers other than C corporations generally could take a deduction for a contribution of food inventory only for the $4 basis in either example.) Taxpayers that do not account for inventories under section 471 and who are not required to capitalize indirect costs under section 263A would be able to elect to treat the basis of the contributed food as being equal to 25 percent of the food's fair market value.

Under the proposal, the enhanced deduction is available only for food that qualifies as "apparently wholesome food." "Apparently wholesome food" is defined 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 provides 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 is determined without regard to such internal standards or lack of market and by taking into account the price at which the same or substantially the same food items (as to both type and quality) are sold by the taxpayer at the time of the contribution or, if not so sold at such time, in the recent past.

Effective Date

The proposal is effective for contributions made in taxable years beginning after December 31, 2005, and before January 1, 2008.

4. Basis adjustment to stock of S corporation contributing 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.[32] A shareholder of an S corporation reduces the basis in the stock of the S corporation by the amount of the charitable contribution that flows through to the shareholder.[33]

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

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

Description of Proposal

The proposal provides that the amount of a shareholder's basis reduction in the stock of an S corporation by reason of a charitable contribution made by the corporation will be equal to the shareholder's pro rata share of the adjusted basis of the contributed property.[34]

Thus, for example, assume an S corporation with one individual shareholder makes a charitable contribution of stock with a basis of $200 and a fair market value of $500. The shareholder will be treated as having made a $500 charitable contribution (or a lesser amount if the special rules of section 170(e) apply), and will reduce the basis of the S corporation stock by $200.

Effective Date

The proposal applies to contributions made in taxable years beginning after December 31, 2005, and before January 1, 2008.

5. Modify tax treatment of certain payments to controlling exempt organizations and public disclosure of information relating to UBIT

Present Law

Payments to controlling exempt organizations

In general, interest, rents, royalties, and annuities are excluded from the unrelated business income of tax-exempt organizations. However, section 512(b)(13) generally treats otherwise excluded rent, royalty, annuity, and interest income as unrelated business income if such income is received from a taxable or tax-exempt subsidiary that is 50 percent controlled by the parent tax-exempt organization. In the case of a stock subsidiary, "control" means ownership by vote or value of more than 50 percent of the stock. In the case of a partnership or other entity, control means ownership of more than 50 percent of the profits, capital or beneficial interests. In addition, present law applies the constructive ownership rules of section 318 for purposes of section 512(b)(13). Thus, a parent exempt organization is deemed to control any subsidiary in which it holds more than 50 percent of the voting power or value, directly (as in the case of a first-tier subsidiary) or indirectly (as in the case of a second-tier subsidiary).

Under present law, interest, rent, annuity, or royalty payments made by a controlled entity to a tax-exempt organization are includable in the latter organization's unrelated business income and are subject to the unrelated business income tax to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity (determined as if the entity were tax exempt).

[34] *See* Rev. Rul. 96-11 (1996-1 C.B. 140) for a rule reaching a similar result in the case of charitable contributions made by a partnership.

The Taxpayer Relief Act of 1997 (the "1997 Act") made several modifications to the control requirement of section 512(b)(13). In order to provide transitional relief, the changes made by the 1997 Act do not apply to any payment received or accrued during the first two taxable years beginning on or after the date of enactment of the 1997 Act (August 5, 1997) if such payment is received or accrued pursuant to a binding written contract in effect on June 8, 1997, and at all times thereafter before such payment (but not pursuant to any contract provision that permits optional accelerated payments).

<u>Public disclosure of returns</u>

In general, an organization described in section 501(c) or (d) is required to make available for public inspection a copy of its annual information return (Form 990) and exemption application materials.[35] A penalty may be imposed on any person who does not make an organization's annual returns or exemption application materials available for public inspection. The penalty amount is $20 for each day during which a failure occurs. If more than one person fails to comply, each person is jointly and severally liable for the full amount of the penalty. The maximum penalty that may be imposed on all persons for any one annual return is $10,000. There is no maximum penalty amount for failing to make exemption application materials available for public inspection. Any person who willfully fails to comply with the public inspection requirements is subject to an additional penalty of $5,000.[36]

These requirements do not apply to an organization's annual return for unrelated business income tax (generally Form 990-T).[37]

<u>Description of Proposal</u>

<u>Payments to controlling exempt organizations</u>

The proposal provides that the general rule of section 512(b)(13), which includes interest, rent, annuity, or royalty payments made by a controlled entity to a tax-exempt organization in the latter organization's unrelated business income to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity, applies only to the portion of payments received or accrued in a taxable year that exceed the amount of the specified payment that would have been paid or accrued if such payment had been determined under the principles of section 482. Thus, if a payment of rent by a controlled subsidiary to its tax-exempt parent organization exceeds fair market value, the excess amount of such payment over fair market value (as determined in accordance with section 482) is included in the parent organization's unrelated business income, to the extent that such excess reduced the net unrelated income (or increased any net unrelated loss) of the controlled entity (determined as if the entity were tax exempt). In addition, the provision imposes a 20-percent penalty on the larger of such

[35] Sec. 6104(d).

[36] Sec. 6685.

[37] Treas. Reg. sec. 301.6104(d)-1(b)(4)(ii).

excess determined without regard to any amendment or supplement to a return of tax, or such excess determined with regard to all such amendments and supplements.

The proposal provides that if modifications to section 512(b)(13) made by the 1997 Act did not apply to a contract because of the transitional relief provided by the 1997 Act, then such modifications also do not apply to amounts received or accrued under such contract before January 1, 2001.

Require public availability of unrelated business income tax returns

The proposal extends the present-law public inspection and disclosure requirements and penalties applicable to the Form 990 to the unrelated business income tax returns of charitable organizations.[38] The proposal provides that certain information may be withheld by the organization from public disclosure and inspection if public availability would adversely affect the organization, similar to the information that may be withheld under present law with respect to applications for tax exemption and the Form 990 (e.g., information relating to a trade secret, patent, process, style of work, or apparatus of the organization, if the Secretary determines that public disclosure of such information would adversely affect the organization).

Require a UBIT certification for certain large charitable organizations

A charitable organization that normally has annual total gross revenues (including contributions and grants, program service revenue, investment income, and revenues from an unrelated trade or business or other sources) or gross assets of at least $10 million must include with its Form 990 and Form 990-T filings (if any) a certification by an independent auditor or by independent counsel that the organization's filings accurately reflect the unrelated business income tax liability of the organization for the taxable year.

The certification must attest that the independent auditor or counsel with respect to the taxable year that is the subject of the return:

1. has reviewed the trades and businesses of the organization, the organization's sources of investment income, and the organization's sources of program service revenues, and, to the best of his or her knowledge, the reporting and descriptions of such items as contained in the Form 990 and, where applicable, Form 990-T, are complete and accurate;

2. reasonably believes that the organization's expense allocations between exempt, unrelated business income activities, and other activities used to determine the organization's unrelated business income tax comply with the requirements set forth in Treasury Regulations section 1.512(a)-1; and

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[38] For purposes of this proposal, a charitable organization is any organization described in section 501(c)(3) and exempt from tax under section 501(a).

3. has or has not reviewed or provided a tax opinion regarding the organization's treatment of income or an activity under the unrelated business income tax rules.[39]

Failure to satisfy the certification requirement results in a penalty, imposed on the organization, of one half of one percent (0.5 percent) of the organization's total gross revenues for the taxable year, excluding revenues from contributions and grants.

Effective Date

The proposal related to payments to controlling organizations applies to payments received or accrued after December 31, 2000. The public availability requirements of the proposal apply to returns filed after the date of enactment. The certification requirement applies to returns for taxable years that begin after the date of enactment.

6. Encourage contributions of real property made for conservation purposes

Present Law

Charitable contributions generally

In general, a deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization. The amount of deduction generally equals the fair market value of the contributed property on the date of the contribution. Charitable deductions are provided for income, estate, and gift tax purposes.[40]

In general, in any taxable year, charitable contributions by a corporation are not deductible to the extent the aggregate contributions exceed 10 percent of the corporation's taxable income computed without regard to net operating or capital loss carrybacks. For individuals, the amount deductible is a percentage of the taxpayer's contribution base, which is the taxpayer's adjusted gross income computed without regard to any net operating loss carryback. The applicable percentage of the contribution base varies depending on the type of donee organization and property contributed. Cash 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. Cash contributions to private foundations and certain other organizations generally may be deducted up to 30 percent of the taxpayer's contribution base.

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 while also either retaining an interest in that property or transferring an interest in that property to a noncharity for less than full and

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[39] If the certifying party has provided or reviewed such an opinion, it also must include a description of the material facts regarding the income or activity that was the subject of such opinion.

[40] Secs. 170, 2055, and 2522, respectively.

adequate consideration. 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, present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property, and qualified conservation contributions.

Capital gain property

Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property to a qualified charity are deductible at fair market value within certain limitations. Contributions of capital gain property to charitable organizations described in section 170(b)(1)(A) (e.g., public charities, private foundations other than private non-operating foundations, and certain governmental units) generally are deductible up to 30 percent of the taxpayer's contribution base. An individual may elect, however, to bring all these contributions of capital gain property for a taxable year within the 50-percent limitation category by reducing the amount of the contribution deduction by the amount of the appreciation in the capital gain property. Contributions of capital gain property to charitable organizations described in section 170(b)(1)(B) (e.g., private non-operating foundations) are deductible up to 20 percent of the taxpayer's contribution base.

For purposes of determining whether a taxpayer's aggregate charitable contributions in a taxable year exceed the applicable percentage limitation, contributions of capital gain property are taken into account after other charitable contributions. Contributions of capital gain property that exceed the percentage limitation may be carried forward for five years.

Qualified conservation contributions

Qualified conservation contributions are not subject to the "partial interest" rule, which generally bars deductions for charitable contributions of partial interests in property. A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. A qualified real property interest is defined as: (1) the entire interest of the donor other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use that may be made of the real property. Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations. Conservation purposes include: (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy; and (4) the preservation of an historically important land area or a certified historic structure.

Qualified conservation contributions of capital gain property are subject to the same limitations and carryover rules of other charitable contributions of capital gain property.

Description of Proposal

In general

Under the proposal, the 30-percent contribution base limitation on contributions of capital gain property by individuals does not apply to qualified conservation contributions (as defined under present law). Thus, individuals may include the fair market value of any qualified conservation contribution of capital gain property in determining the amount of the charitable contributions subject to the 50-percent contribution base limitation.

Individuals are allowed to carryover any qualified conservation contributions that exceed the 50-percent limitation for up to 15 years. The 50-percent contribution base limitation applies first to contributions other than qualified conservation contributions and then to qualified conservation contributions. For example, assume an individual with a contribution base of $100 makes a qualified conservation contribution of property with a fair market value of $80 and makes other charitable contributions subject to the 50 percent limitation of $60. The individual is allowed a deduction of $50 in the current taxable year for the other contributions (50 percent of the $100 contribution base) and is allowed to carryover the excess $10 for up to 5 years. No current deduction is allowed for the qualified conservation contribution but the entire $80 qualified conservation contribution may be carried forward for up to 15 years.

Farmers and ranchers

In the case of an eligible farmer or rancher, a qualified conservation contribution is allowable up to 100 percent of the taxpayer's contribution base (after taking into account other charitable contributions). This rule applies both to individuals and corporations. In addition, corporate (as well as non-corporate) eligible farmers and ranchers are allowed to carryover any excess qualified conservation contributions for up to 15 years. The 100-percent contribution base limitation applies first to contributions other than qualified conservation contributions (to the extent allowable under other percentage limitations) and then to qualified conservation contributions. For example, assume an individual farmer or rancher with a contribution base of $100 makes a qualified conservation contribution of property with a fair market value of $80 and makes other charitable contributions subject to the 50 percent limitation of $60. The individual is allowed a deduction of $50 in the current taxable year for the other contributions (50 percent of the $100 contribution base) and is allowed to carryover the excess $10 for up to 5 years. The individual also is allowed a deduction of $50 in the current taxable year for the qualified charitable contribution (the amount of the remaining contribution base). The remaining $30 qualified conservation contribution may be carried forward for up to 15 years.

For this purpose, an eligible farmer or rancher means a taxpayer (other than a publicly traded C corporation) whose gross income from the trade of business of farming is at least 51 percent of the taxpayer's gross income for the taxable year.

Effective Date

The proposal is effective for contributions made in taxable years beginning after December 31, 2005 and before January 1, 2008.

7. Charitable deduction for contributions of book 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, or if less the fair market value of the inventory.

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 appreciation (i.e., basis plus one half of fair market value in excess of basis) or (2) two times basis (sec. 170(e)(3)). In general, a C corporation's charitable contribution deductions for a year may not exceed 10 percent of the corporation's taxable income (sec. 170(b)(2)). 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)(3) (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.

A donor making a charitable contribution of inventory must make a corresponding adjustment to the cost of goods sold by decreasing the cost of goods sold by the lesser of the fair market value of the property or the donor's basis with respect to the inventory (Treas. Reg. sec. 1.170A-4A(c)(3)). Accordingly, if the allowable charitable deduction for inventory is the fair market value of the inventory, the donor reduces its cost of goods sold by such value, with the result that the difference between the fair market value and the donor's basis may still be recovered by the donor other than as a charitable contribution.

To use the enhanced deduction, the taxpayer must establish that the fair market value of the donated item exceeds basis.

Description of Proposal

The proposal modifies the present-law enhanced deduction for C corporations so that it is equal to the lesser of fair market value or twice the taxpayer's basis in the case of qualified book contributions. The proposal provides that the fair market value for this purpose is determined by reference to a bona fide published market price for the book. Under the proposal, a bona fide published market price of a book is a price of a book, determined using the same printing and same edition, published within seven years preceding the contribution, determined as a result of an arm's length transaction, and for which the book was customarily sold. For example, a publisher's listed retail price for a book would not meet the standard if the publisher could not demonstrate to the satisfaction of the Secretary that the price was one at which the book was customarily sold and was the result of an arm's length transaction. If a publisher entered into a contract with a local school district to sell newly published textbooks six years prior to making a qualified book contribution of such textbooks, the publisher could use as a bona fide published market price, the price at which such books regularly were sold to the school district under the contract. By contrast, if a publisher listed in a catalogue or elsewhere a "suggested retail price," but books were not in fact customarily sold at such price, the publisher could not use the "suggested retail price" to determine the fair market value of the book for purposes of the enhanced deduction. Thus, in general, a bona fide published market price must be independently verifiable by reference to actual sales within the seven-year period preceding the contribution, and not to a publisher's own price list.

As an illustration of the mechanics of calculating the enhanced deduction under the proposal, a C corporation that made a qualified book contribution with a bona fide published market price of $10 and a basis of $4 could take a deduction of $8 (twice basis). If the taxpayer's basis is $6 instead of $4, then the deduction is $10. Also, in such latter case, if the book's bona fide market published market price was $5 at the time of the contribution but was $10 five years before the contribution, then the deduction is $10.

A qualified book contribution means a charitable contribution of books to: (1) an educational organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on; (2) a public library; or (3) an organization described in section 501(c)(3) (except for private nonoperating foundations), that is organized primarily to make books available to the general public at no cost or to operate a literacy program. The donee must: (1) use the property consistent with the donee's exempt purpose; (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 and also that the books are suitable, in terms of currency, content, and quantity, for use in the donee's educational programs and that the donee will use the books in such educational programs.

Effective Date

The proposal is effective for contributions made in taxable years beginning after December 31, 2005, and before January 1, 2008.

8. Tax involvement by exempt organizations in tax-shelter transactions

Present Law

Disclosure of listed and other reportable transactions by taxpayers

Present law provides that a taxpayer that participates in a reportable transaction (including a listed transaction) and who is required to file a tax return must attach to its return a disclosure statement in the form prescribed by the Secretary.[41] For this purpose, the term

[41] Treas. Reg. sec. 1.6011-4(a).

taxpayer includes any person, including an individual, trust, estate, partnership, association, company, or corporation.[42]

Under existing regulations, a reportable transaction includes a listed transaction and five other categories of transactions: (1) confidential transactions, which are transactions offered to a taxpayer under conditions of confidentiality and for which the taxpayer has paid an advisor a minimum fee; (2) transactions with contractual protection, which include transactions for which the taxpayer or a related party has the right to a full or partial refund of fees if all or part of the intended tax consequences from the transaction are not sustained, or for which fees are contingent on the taxpayer's realization of tax benefits from the transaction; (3) loss transactions, which are transactions resulting in the taxpayer claiming a loss under section 165 that exceeds certain thresholds, depending upon the type of taxpayer; (4) transactions with a significant book-tax difference; and (5) transactions involving a brief asset holding period.[43] A listed transaction means a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011 (relating to the filing of returns and statements), and identified by notice, regulation, or other form of published guidance as a listed transaction.[44] The fact that a transaction is a reportable transaction does not affect the legal determination of whether the taxpayer's treatment of the transaction is proper.[45] Present law authorizes the Secretary to define reportable transaction on the basis of such transaction being of a type which the Secretary determines as having a potential for tax avoidance or evasion.[46]

Treasury regulations provide guidance regarding the determination of when a taxpayer participates in a transaction for these purposes.[47] A taxpayer has participated in a listed transaction if the taxpayer's tax return reflects tax consequences or a tax strategy described in the published guidance that lists the transaction, or if the taxpayer knows or has reason to know that the taxpayer's tax benefits are derived directly or indirectly from tax consequences or a tax strategy described in published guidance that lists a transaction. A taxpayer has participated in a confidential transaction if the taxpayer's tax return reflects a tax benefit from the transaction and the taxpayer's disclosure of the tax treatment or tax structure of the transaction is limited under conditions of confidentiality. A taxpayer has participated in a transaction with contractual protection if the taxpayer's tax return reflects a tax benefit from the transaction, and the taxpayer has the right to the full or partial refund of fees or the fees are contingent.

Present law provides a penalty for any person who fails to include on any return or statement any required information with respect to a reportable transaction.[48] The penalty

[42] Sec. 7701(a)(1); Treas. Reg. sec. 1.6011-4(c)(1).

[43] Treas. Reg. sec. 1.6011-4(b).

[44] Sec. 6707A(c)(2); Treas. Reg. sec. 1.6011-4(b)(2).

[45] Treas. Reg. sec. 1.6011-4(a).

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

[47] Treas. Reg. sec. 1.6011-4(c)(3).

[48] Sec. 6707A.

applies without regard to whether the transaction ultimately results in an understatement of tax, and applies in addition to any other penalty that may be imposed.

The penalty for failing to disclose a reportable transaction is $10,000 in the case of a natural person and $50,000 in any other case. The amount is increased to $100,000 and $200,000, respectively, if the failure is with respect to a listed transaction. The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the IRS Commissioner may rescind all or a portion of the penalty if rescission would promote compliance with the tax laws and effective tax administration.

Disclosure of listed and other reportable transactions by material advisors

Present law requires each material advisor with respect to any reportable transaction (including any listed transaction) to timely file an information return with the Secretary (in such form and manner as the Secretary may prescribe).[49] The information return must include (1) information identifying and describing the transaction, (2) information describing any potential tax benefits expected to result from the transaction, and (3) such other information as the Secretary may prescribe. The return must be filed by the date specified by the Secretary.

A "material advisor" means any person (1) who provides material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction, and (2) who directly or indirectly derives gross income in excess of $250,000 ($50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons) or such other amount as may be prescribed by the Secretary for such advice or assistance.[50]

The Secretary may prescribe regulations which provide (1) that only one material advisor is required to file an information return in cases in which two or more material advisors would otherwise be required to file information returns with respect to a particular reportable transaction, (2) exemptions from the requirements of this section, and (3) other rules as may be necessary or appropriate to carry out the purposes of this section.[51]

Present law imposes a penalty on any material advisor who fails to timely file an information return, or who files a false or incomplete information return, with respect to a reportable transaction (including a listed transaction).[52] The amount of the penalty is $50,000. If the penalty is with respect to a listed transaction, the amount of the penalty is increased to the greater of (1) $200,000, or (2) 50 percent of the gross income derived by such person with respect to aid, assistance, or advice which is provided with respect to the transaction before the date the information return that includes the transaction is filed. An intentional failure or act by a

[49] Sec. 6707(a), as added by the American Jobs Creation Act of 2004, P.L. No. 108-357, sec. 816(a).

[50] Sec. 6707(b)(1).

[51] Sec. 6707(c).

[52] Sec. 6707(b).

material advisor with respect to the requirement to disclose a listed transaction increases the penalty to 75 percent of the gross income derived from the transaction.

The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the IRS Commissioner can rescind all or a portion of the penalty if rescission would promote compliance with the tax laws and effective tax administration.

Description of Proposal

In general

In general, under the proposal, many tax-exempt entities are subject to penalties for participating in a prohibited tax shelter transaction as accommodation parties. A prohibited tax shelter transaction is a transaction that the Secretary determines is a listed transaction (as defined in section 6707A(c)(2)) or a reportable transaction that is a confidential transaction or a transaction with contractual protection (as defined by the Secretary in regulations). The proposal also clarifies that an exempt organization that participates in a reportable transaction (including a listed transaction) in order to shelter from tax the organization's own tax liability (e.g., the unrelated business income tax) is subject to the present-law rules (sec. 6707A and sec. 6011) pertaining to disclosure of such transactions.

The proposal generally applies to all tax-exempt organizations and entities organized in the United States, including charitable and other organizations described in section 501(c) (other than instrumentalities of the United States, i.e., section 501(c)(1) organizations, and foreign organizations, i.e., section 501(c)(3) organizations not organized in the United States), State and local governments, Indian tribal governments, and tax qualified pension plans, individual retirement arrangements ("IRAs"), and similar tax-favored savings arrangements (such as Coverdell education savings accounts, health savings accounts, and qualified tuition plans).

Entity level tax

Under the proposal, if a tax-exempt entity participates in a transaction, knowing or with reason to know that the transaction is a prohibited tax shelter transaction, the entity is subject to a tax of the greater of 100 percent of the entity's net income (after taking into account any income tax imposed with respect to the transaction) or 75 percent of the gross proceeds that is attributable to the entity's participation in the prohibited transaction.

In addition, if a transaction is not a tax shelter prohibited transaction at the time a tax-exempt entity participates in the transaction, but the transaction subsequently is determined by the Secretary to be a prohibited tax shelter transaction (a "subsequently prohibited tax shelter transaction"), the entity must pay an excise tax at the highest unrelated business taxable income rate times the greater of (i) any income that is properly allocable to the transaction after the time the transaction becomes prohibited, and (ii) 75 percent of the gross income properly allocable to the organization from the transaction after the time the transaction becomes prohibited. The Secretary has the authority to provide guidance regarding the determination of the allocation of net income of a tax-exempt entity that is attributable to a transaction to various periods, including before and after the listing of the transaction.

Neither entity level tax applies if the entity's participation is not willful and is due to reasonable cause. The entity level taxes do not apply to tax qualified pension plans, IRAs, and similar tax-favored savings arrangements (such as Coverdell education savings accounts, health savings accounts, and qualified tuition plans).

Disclosure of participation in prohibited tax shelter transactions

A person who fails to include information with respect to a prohibited tax shelter transaction on any return or statement as required by the Secretary must pay a penalty of $10,000 in the case of a natural person or $50,000 in any other case. In addition, the proposal requires that a party to a prohibited tax shelter transaction that is not a tax-exempt entity disclose to the tax-exempt entity that the transaction is a prohibited tax shelter transaction. Failure to make such disclosure is subject to the penalties described above.

The proposal requires disclosure by a tax-exempt entity to the IRS of each participation in a prohibited tax shelter transaction and disclosure of other known parties to the transaction if the tax-exempt entity knows that such transaction is a reportable transaction. The penalty for failure to disclose is imposed on the entity (or entity manager, in the case of qualified pension plans and similar tax favored retirement arrangements) at $100 per day the failure continues, not to exceed $50,000. If any person fails to comply with a demand for payment by the Secretary of such penalty, such person or persons shall pay a penalty of $100 per day (beginning on the date of the failure to comply) not to exceed $10,000 per reportable transaction.

Penalty on entity managers

A penalty of $20,000 is imposed on each entity manager that approves or otherwise causes a tax-exempt entity's participation in a prohibited tax shelter transaction, knowing or with reason to know that the transaction is a prohibited tax shelter transaction. An entity manager is defined as a person with authority or responsibility similar to that exercised by an officer, director, or trustee of an organization, except: (1) in the case of an entity described in section 501(c)(3) or (c)(4), an entity manager is an organization manager as defined in section 4958(f)(2), and (2) in the case of tax qualified pension plans, IRAs, and similar tax-favored savings arrangements (such as Coverdell education savings accounts, health savings accounts, and qualified tuition plans), an entity manager is a person responsible for causing the entity to participate in the prohibited tax shelter transaction.

Effective Date

The proposal generally is effective for transactions after the date of enactment, except that no tax applies with respect to income that is properly allocable to the period ending on the date that is 90 days after the date of enactment. The effective date for disclosure obligations and penalties for failure to disclose is returns and statements the due date of which is after the date of enactment.

9. Apply an excise tax to acquisitions of interests in insurance contracts in which certain exempt organizations hold an interest

Present Law

Amounts received under a life insurance contract

Amounts received under a life insurance contract paid by reason of the death of the insured are not includible in gross income for Federal tax purposes.[53] No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract (inside buildup).[54]

Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income to the extent that the amounts distributed exceed the taxpayer's investment in the contract (i.e., basis). Such distributions generally are treated first as a tax-free recovery of basis, and then as income.[55]

Transfers for value

A limitation on the exclusion for amounts received under a life insurance contract is provided in the case of transfers for value. If a life insurance contract (or an interest in the contract) is transferred for valuable consideration, the amount excluded from income by reason of the death of the insured is limited to the actual value of the consideration plus the premiums and other amounts subsequently paid by the acquiror of the contract.[56]

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[53] Sec. 101(a).

[54] This favorable tax treatment is available only if a life insurance contract meets certain requirements designed to limit the investment character of the contract (sec. 7702).

[55] Sec. 72(e). In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10-percent tax is imposed on the income portion of distributions made before age 59-1/2 and in certain other circumstances (secs. 72(e) and (v)). A modified endowment contract is a life insurance contract that does not meet a statutory "7-pay" test, i.e., generally is funded more rapidly than seven annual level premiums (sec. 7702A).

[56] Section 101(a)(2). The transfer-for-value rule does not apply, however, in the case of a transfer in which the life insurance contract (or interest in the contract) transferred has a basis in the hands of the transferee that is determined by reference to the transferor's basis. Similarly, the transfer-for-value rule generally does not apply if the transfer is between certain parties (specifically, if the transfer is to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer).

Tax treatment of charitable organizations and donors

Present law generally provides tax-exempt status for charitable, educational and certain other organizations, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and which meet certain other requirements.[57] Governmental entities, including some educational organizations, are exempt from tax on income under other tax rules providing that gross income does not include income derived from the exercise of any essential governmental function and accruing to a State or any political subdivision thereof.[58]

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 501(c)(3) or to a Federal, State, or local governmental entity for exclusively public purposes.[59]

State-law insurable interest rules

State laws generally provide that the owner of a life insurance contract must have an insurable interest in the insured person when the life insurance contract is issued. State laws vary as to the insurable interest of a charitable organization in the life of any individual. Some State laws provide that a charitable organization meeting the requirements of section 501(c)(3) of the Code is treated as having an insurable interest in the life of any donor,[60] or, in other States, in the life of any individual who consents (whether or not the individual is a donor).[61] Other States' insurable interest rules permit the purchase of a life insurance contract even though the person paying the consideration has no insurable interest in the life of the person insured if a charitable, benevolent, educational or religious institution is designated irrevocably as the beneficiary.[62]

Transactions involving charities and non-charities acquiring life insurance

Recently, there has been an increase in transactions involving the acquisition of life insurance contracts using arrangements in which both exempt organizations, primarily charities,

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[57] Section 501(c)(3).

[58] Section 115.

[59] Section 170.

[60] See, e.g., Mass. Gen. Laws Ann. ch. 175, sec. 123A(2) (West 2005); Iowa Code Ann. sec. 511.39 (West 2004) ("a person who, when purchasing a life insurance policy, makes a donation to the charitable organization or makes the charitable organization the beneficiary of all or a part of the proceeds of the policy . . . ").

[61] See, e.g., Cal. Ins. Code sec. 10110.1(f) (West 2005); 40 Pa. Cons. Stat. Ann. sec. 40-512 (2004); Fla. Stat. Ann. sec. 27.404 (2) (2004); Mich. Comp. Laws Ann. sec. 500.2212 (West 2004).

[62] Or. Rev. Stat. sec. 743.030 (2003); Del. Code Ann. Tit. 18, sec. 2705(a) (2004).

and private investors have an interest in the contract.[63] The exempt organization has an insurable interest in the insured individuals, either because they are donors, because they consent, or otherwise under applicable State insurable interest rules. Private investors provide capital used to fund the purchase of the life insurance contracts, sometimes together with annuity contracts. Both the private investors and the charity have an interest in the contracts, directly or indirectly, through the use of trusts, partnerships, or other arrangements for sharing the rights to the contracts. Both the charity and the private investors receive cash amounts in connection with the investment in the contracts while the life insurance is in force or as the insured individuals die.

Description of Proposal

The proposal imposes an excise tax, equal to 100 percent of the acquisition costs, on the taxable acquisition of any interest in an applicable insurance contract. An applicable insurance contract is any life insurance, annuity or endowment contract in which both an applicable exempt organization and any person that is not an applicable exempt organization have, directly or indirectly, held an interest in the contract (whether or not the interests are held at the same time).

An applicable exempt organization is any organization described in section 170(c), 168(h)(2)(A)(iv), 2055(a), or 2522(a). Thus, for example, an applicable exempt organization generally includes an organization that is exempt from Federal income tax by reason of being described in section 501(c)(3) (including one organized outside the United States), a government or political subdivision of a government, and an Indian tribal government.

A taxable acquisition is the acquisition of any direct or indirect interest in an applicable insurance contract by an applicable exempt organization, or by any other person if the interest in the contract in that person's hands is not described in the specific exceptions to "applicable insurance contract."

Under the provision, acquisition costs mean the direct or indirect costs (including premiums, commissions, fees, charges, or other amounts) of acquiring or maintaining an interest in an applicable insurance contract. Except as provided in regulations, if acquisition costs of any taxable acquisition are paid or incurred in more than one calendar year, the excise tax under the provision is imposed each year with respect to costs are paid or incurred during that year. In the case of an acquisition of an interest in an entity that directly or indirectly holds an interest in an applicable insurance contract, acquisition costs are intended to include the amount of money or value of property (including an applicable insurance contract) contributed to an entity or otherwise transferred or paid to acquire or increase an interest in the entity, that directly or indirectly holds an interest in an applicable insurance contract.

For example, acquisition costs include (1) each premium, commission, or fee with respect to the contract, (2) each amount paid or incurred to acquire or increase an interest in the contract, (3) each amount paid or incurred to acquire or increase an interest in an entity (such as a partnership, trust, corporation, or other type of entity or arrangement) that has a direct or indirect

[63] Davis, Wendy, "Death-Pool Donations," Trusts and Estates, May 2004, 55; Francis, Theo, "Tax May Thwart Investment Plans Enlisting Charities," Wall St. J., Feb. 8, 2005, A-10.

interest in the contract, and (4) if the contract is contributed to an entity, the greater of the value of the contract or the total amount of premiums, commissions, and fees paid or incurred to acquire and maintain the insurance contract. It is intended that, under regulatory authority provided as necessary to carry out the purposes of the provision, any other similar or economically equivalent amount paid or incurred is to be treated as acquisition costs.

Under the provision, an interest in an applicable insurance contract includes any right with respect to the contract, whether as an owner, beneficiary, or otherwise. An indirect interest in a contract includes an interest in an entity that, directly or indirectly, holds an interest in the contract. In the case of a section 1035 exchange of an applicable insurance contract, any interest in any of the contracts involved in the exchange is treated as an interest in all such contracts. An increase in an interest in an applicable insurance contract is treated as a separate acquisition, for purposes of application of the excise tax under the provision.

If an interest of an applicable exempt organization exists solely because the organization holds, as part of a diversified investment strategy, a de minimis interest in an entity which directly or indirectly holds an interest in the contract, such interest is not taken into account for purposes of the proposal. For example, if an applicable exempt organization owns a de minimis amount of stock in a corporation which in turn owns life insurance contracts covering key employees, the excise tax under the provision does not apply because the stock ownership is not treated as an indirect interest in this circumstance. It is intended that Treasury regulations provide guidance as to the application of this rule so that it does not permit circumvention of the provision.

Except as provided in regulations, if a person acquires an interest in a contract before the contract is treated as an applicable insurance contract, the acquisition is treated as a taxable acquisition of an interest in applicable insurance contract as of the date the contract becomes an applicable insurance contract.

It is intended that an interest in an applicable insurance contract includes, for example, (1) a right with respect to the applicable insurance contract pursuant to a side contract or other similar arrangement, (2) an interest as a trust beneficiary in distributions from or income of a trust holding an interest in a contract, and (3) a right to distributions, guaranteed payments, or income of a partnership that holds an interest in a contract. It is not intended that a right with respect to the contract include typical rights of issuers of applicable insurance contracts.

Exceptions to the term “applicable insurance contract” apply under the proposal. First, the term does not apply if each person (other than an applicable exempt organization) with a direct or indirect interest in the contract has an insurable interest in the insured independent of any interest of the exempt organization in the contract. Second, the term does not apply if the sole interest in the contract of each person other than the applicable exempt organization is as a named beneficiary. Third, the term does not apply if the sole interest in the contract of each person other than the applicable exempt organization is either (1) as a beneficiary of a trust holding an interest in the contract, but only if the person’s designation as such a beneficiary was made without consideration and solely on a purely gratuitous basis, or (2) as a trustee who holds an interest in the contract in a fiduciary capacity solely for the benefit of applicable exempt organizations or of persons otherwise meeting one of the first two exceptions.

An exception to the term "applicable insurance contract" also is provided under the proposal in certain cases in which a person other than an applicable exempt organization has an interest solely as a lender[64] with respect to the contract, and the contract covers only one individual who is an officer, director, or employee of the applicable exempt organization with an interest in the contract, provided other requirements are met. This exception applies only if the number of insured persons under loans by such lenders with respect to such contracts does not exceed the greater of: (1) the lesser of 5 percent of the total officers, directors, and employees of the organization or 20, or (2) 5. Under this exception, the aggregate amount of indebtedness with respect to 1 or more contracts covering a single individual may not exceed $50,000.

In addition, Treasury regulatory authority is provided to except certain contracts from treatment as applicable insurance contracts. Contracts may be excepted based on specific factors including (1) whether the transaction is at arms' length, (2) whether the economic benefits to the applicable exempt organization substantially exceed the economic benefits to all other persons with an interest in the contract (determined without regard to whether, or the extent to which, such organization has paid or contributed with respect to the contract), and (3) the likelihood of abuse.

The application of the exceptions can be illustrated as follows. Assume that an individual acquires a life insurance contract in which the individual is the insured person, and the named beneficiaries are the individual's son and a university that is an organization described in section 170(c). The contract is not an applicable insurance contract because the first exception applies. That is, because both the individual and his son have an insurable interest in the individual, all persons holding any interest in the contract (other than applicable exempt organizations) have an insurable interest in the insured independent of any interest of an applicable exempt organization in the contract. The second exception also applies in this situation.

As another example, assume that the three named beneficiaries are the insured's son, an unrelated friend, and a charity. The contract is not an applicable insurance contract because the second exception applies. That is, each beneficiary's sole interest is as a named beneficiary. In addition, the first exception also applies in this situation.

As a further example, assume that the insured individual creates an irrevocable trust for the benefit of the insured's descendants, and that the trustee of the trust uses trust funds to purchase a life insurance policy on the insured's life, and the trust is both the owner and beneficiary of the insurance policy. The insured individual's naming of his or her descendants as trust beneficiaries is a gratuitous act, done without consideration. As a result, the contract is not an applicable insurance contract under the third exception.

No Federal income tax deduction is permitted for the excise tax payable under the proposal, as provided under the rule of Code section 275(a)(6). The amount of the excise tax

[64] For this purpose, an interest as a lender includes a security interest in the insurance contract to which the loan relates.

payable under the proposal is not included in the investment in the contract for purposes of section 72.

Treasury regulatory authority is provided to carry out the purposes of the provision. This includes authority to provide appropriate rules in the case in which a person acquires an interest before a contract is treated as an applicable insurance contract. This also includes authority to prevent, in cases the Treasury Secretary determines appropriate, the imposition of more than one tax if the same interest is acquired more than once (otherwise, the tax under the provision applies to each acquisition). Treasury regulatory authority is also provided to prevent avoidance of the provision, including through the use of intermediaries.

The proposal provides reporting rules requiring an applicable exempt organization or other person that makes a taxable acquisition of an applicable insurance contract to file a return containing required information and such other information as is prescribed by the Treasury Secretary. Under these rules, a statement is required to be furnished to each person whose taxpayer identification information is required to be reported on the return. Penalties apply for failure to file the return or furnish the statement, including, in the case of intentional disregard of the return filing requirement, a penalty equal to the amount of the excise tax that has not been paid with respect to the items required to be included on the return.

Effective Date

The provision is effective for contracts issued after May 3, 2005.

The application of the effective date with respect to prior acquisitions of interests may be illustrated as follows. Assume that an exempt organization and a person that is not an exempt organization described in section 170(c) form a partnership before May 3, 2005. After May 3, 2005, the partnership acquires an interest in a life insurance contract that is issued after May 3, 2005. The acquisition by the partnership of the interest in the contract is treated as a taxable acquisition under the provision by each of the partners (i.e., the exempt organization and the other person).

The provision also requires reporting of existing life insurance, endowment and annuity contracts issued on or before that date, in which an applicable exempt organization holds an interest on that date and which would be treated as an applicable insurance contract under the provision. This reporting is required within one year after the date of enactment.

10. Increase the amounts of excise taxes imposed on public charities, social welfare organizations, and private foundations

Present Law

Public charities and social welfare organizations

The Code imposes excise taxes on excess benefit transactions between disqualified persons (as defined in section 4958(f)) and charitable organizations (other than private foundations) or social welfare organizations (as described in section 501(c)(4)).[65] An excess benefit transaction generally is a transaction in which an economic benefit is provided by a charitable or social welfare organization directly or indirectly 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 excess benefit tax is imposed on the disqualified person and, in certain cases, on the organization manager, 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 $10,000 with respect to any excess benefit transaction) is imposed on an organization manager that 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.[66] 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.[67]

Private foundations

Self-dealing by private foundations

Excise taxes are imposed on acts of self-dealing between a disqualified person (as defined in section 4946) and a private foundation.[68] In general, self-dealing transactions are any direct or indirect: (1) sale or exchange, or leasing, of property between a private foundation and a disqualified person; (2) lending of money or other extension of credit between a private foundation and a disqualified person; (3) the furnishing of goods, services, or facilities between a private foundation and a disqualified person; (4) the payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person; (5) the transfer to, or use by or for the benefit of, a disqualified person of the income or assets of the private foundation; and (6) certain payments of money or property to a government official.[69] Certain exceptions apply.[70]

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[65] Sec. 4958. The excess benefit transaction tax is commonly referred to as "intermediate sanctions," because it imposes penalties generally considered to be less punitive than revocation of the organization's exempt status.

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

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

[68] Sec. 4941.

[69] Sec. 4941(d)(1).

[70] See sec. 4941(d)(2).

An initial tax of five 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 2.5-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 $10,000 per act. Such initial taxes may not be abated.[71] 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 $10,000 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.[72]

Tax on failure to distribute income

Private nonoperating foundations are required to pay out a minimum amount each year as qualifying distributions. 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.[73] Failure to pay out the minimum results in an initial excise tax on the foundation of 15 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.[74] 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.[75] Private operating foundations are not subject to the payout requirements.

[71] Sec. 4962(b).

[72] Sec. 4961.

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

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

[75] 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).

Tax on excess business holdings

Private foundations are subject to tax on excess business holdings.[76] In general, a private foundation is permitted to hold 20 percent of the voting stock in a corporation, reduced by the amount of voting stock held by all disqualified persons (as defined in section 4946). If it is established that no disqualified person has effective control of the corporation, a private foundation and disqualified persons together may own up to 35 percent of the voting stock of a corporation. A private foundation shall not be treated as having excess business holdings in any corporation if it owns (together with certain other related private foundations) not more than two percent of the voting stock and not more than two percent in value of all outstanding shares of all classes of stock in that corporation. Similar rules apply with respect to holdings in a partnership ("profits interest" is substituted for "voting stock" and "capital interest" for "nonvoting stock") and to other unincorporated enterprises (by substituting "beneficial interest" for "voting stock"). Private foundations are not permitted to have holdings in a proprietorship. Foundations generally have a five-year period to dispose of excess business holdings (acquired other than by purchase) without being subject to tax.[77] This five-year period may be extended an additional five years in limited circumstances.[78]

The initial tax is equal to five percent of the value of the excess business holdings held during the foundation's applicable taxable year. An additional tax is imposed if an initial tax is imposed and at the close of the applicable taxable period, the foundation continues to hold excess business holdings. The amount of the additional tax is equal to 200 percent of such holdings.

Tax on jeopardizing investments

Private foundations and foundation managers are subject to tax on investments that jeopardize the foundation's charitable purpose.[79] In general, an initial tax of five percent of the amount of the investment applies to the foundation and to foundation managers who participated in the making of the investment knowing that it jeopardized the carrying out of the foundation's exempt purposes. The initial tax on foundation managers may not exceed $5,000 per investment. If the investment is not removed from jeopardy (e.g., sold or otherwise disposed of), an additional tax of 25 percent of the amount of the investment is imposed on the foundation and five percent of the amount of the investment on a foundation manager who refused to agree to removing the investment from jeopardy. The additional tax on foundation managers may not exceed $10,000 per investment. An investment, the primary purpose of which is to accomplish a charitable purpose and no significant purpose of which is the production of income or the appreciation of property, is not considered a jeopardizing investment.[80]

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[76] Sec. 4943. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

[77] Sec. 4943(c)(6).

[78] Sec. 4943(c)(7).

[79] Sec. 4944. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

[80] Sec. 4944(c).

Tax on taxable expenditures

Certain expenditures of private foundations are subject to tax.[81] In general, taxable expenditures are expenses: (1) for lobbying; (2) to influence the outcome of a public election or carry on a voter registration drive (unless certain requirements are met); (3) as a grant to an individual for travel, study, or similar purposes unless made pursuant to procedures approved by the Secretary; (4) as a grant to an organization that is not a public charity or exempt operating foundation unless the foundation exercises expenditure responsibility[82] with respect to the grant; or (5) for any non-charitable purpose. For each taxable expenditure, a tax is imposed on the foundation of 10 percent of the amount of the expenditure, and an additional tax of 100 percent is imposed on the foundation if the expenditure is not corrected. A tax of 2.5 percent of the expenditure (up to $5,000) also is imposed on a foundation manager who agrees to making a taxable expenditure knowing that it is a taxable expenditure. An additional tax of 50 percent of the amount of the expenditure (up to $10,000) is imposed on a foundation manager who refuses to agree to correction of such expenditure.

Description of Proposal

Self-dealing and excess benefit transaction initial taxes and dollar limitations

For acts of self-dealing other than the payment of compensation by a private foundation to a disqualified person, the proposal increases the initial tax on the self-dealer from five percent of the amount involved to 10 percent of the amount involved. For acts of self-dealing regarding the payment of compensation by a private foundation to a disqualified person, the proposal increases the initial tax on the self-dealer from five percent of the amount involved (none of which is subject to abatement) to 25 percent of the amount involved (15 percent of which is subject to abatement). The proposal increases the initial tax on foundation managers from 2.5 percent of the amount involved to five percent of the amount involved and increases the dollar limitation on the amount of the initial and additional taxes on foundation managers per act of self-dealing from $10,000 per act to $20,000 per act. Similarly, the proposal doubles the dollar limitation on organization managers of public charities and social welfare organizations for participation in excess benefit transactions from $10,000 per transaction to $20,000 per transaction.

Failure to distribute income, excess business holdings, jeopardizing investments, and taxable expenditures

The proposal doubles the amounts of the initial taxes and the dollar limitations on foundation managers with respect to the private foundation excise taxes on the failure to distribute income, excess business holdings, jeopardizing investments, and taxable expenditures.

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[81] Sec. 4945. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

[82] In general, expenditure responsibility requires that a foundation make all reasonable efforts and establish reasonable procedures to ensure that the grant is spent solely for the purpose for which it was made, to obtain reports from the grantee on the expenditure of the grant, and to make reports to the Secretary regarding such expenditures. Sec. 4945(h).

Specifically, for the failure to distribute income, the initial tax on the foundation is increased from 15 percent of the undistributed amount to 30 percent of the undistributed amount.

For excess business holdings, the initial tax on excess business holdings is increased from five percent of the value of such holdings to 10 percent of such value.

For jeopardizing investments, the initial tax of five percent of the amount of the investment that is imposed on the foundation and on foundation managers is increased to 10 percent of the amount of the investment. The dollar limitation on the initial tax on foundation managers of $5,000 per investment is increased to $10,000 and the dollar limitation on the additional tax on foundation managers of $10,000 per investment is increased to $20,000.

For taxable expenditures, the initial tax on the foundation is increased from 10 percent of the amount of the expenditure to 20 percent, the initial tax on the foundation manager is increased from 2.5 percent of the amount of the expenditure to five percent, the dollar limitation on the initial tax on foundation managers is increased from $5,000 to $10,000, and the dollar limitation on the additional tax on foundation managers is increased from $10,000 to $20,000.

Effective Date

The proposal is effective for taxable years beginning after the date of enactment.

11. Improve accountability of donor advised funds

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.[83] 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) the net earnings of the organization may not inure to the benefit of any person in a position to influence the activities of the organization; (2) the organization must operate to provide a public benefit, not a private benefit;[84] (3) the organization may not be operated primarily to conduct an unrelated trade or business;[85] (4) the organization may not engage in

[83] 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).

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

[85] 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.

substantial legislative lobbying; and (5) the organization may not participate or intervene in any political campaign.

Classification of section 501(c)(3) organizations

Section 501(c)(3) organizations are classified either as "public charities" or "private foundations."[86] 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.[87] For example, the Code imposes excise taxes on acts of "self-dealing" between disqualified persons (generally, an enumerated class of foundation insiders[88]) and a private foundation. Acts of self-dealing include, for example, sales or exchanges, or leasing, of property; lending of money; or the furnishing of goods, services, or facilities between a disqualified person and a private foundation.[89] In addition, private non-operating foundations are required to pay out a minimum amount each year as qualifying distributions. 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.[90] Certain expenditures of private foundations are also subject to tax.[91] In general, taxable expenditures are expenditures: (1) for lobbying; (2) to influence the outcome of a public election or carry on a voter registration drive (unless certain requirements are met); (3) as a grant to an individual for travel, study, or similar purposes unless made pursuant to procedures

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[86] 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.

[87] Secs. 4940 - 4945.

[88] See sec. 4946(a).

[89] Sec. 4941.

[90] Sec. 4942(g)(1)(A). 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. Sec. 4942(g)(1)(B) and 4942(g)(2).

[91] Sec. 4945. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

approved by the Secretary; (4) as a grant to an organization that is not a public charity or exempt operating foundation unless the foundation exercises expenditure responsibility[92] with respect to the grant; or (5) for any non-charitable purpose. Additional excise taxes may also apply in the event a private foundation holds certain business interests ("excess business holdings")[93] or makes an investment that jeopardizes the foundation's exempt purposes.[94]

Charitable contributions

Contributions to organizations described in section 501(c)(3) are deductible, subject to certain limitations, as an itemized deduction from Federal income taxes.[95] Such contributions also generally are deductible for estate and gift tax purposes.[96] However, if the taxpayer retains control over the assets transferred to charity, the transfer may not qualify as a completed gift for purposes of claiming an income, estate, or gift tax deduction.

Public charities enjoy certain advantages over private foundations regarding the deductibility of contributions. For example, contributions of appreciated capital gain property to a private foundation generally are deductible only to the extent of the donor's cost basis.[97] In contrast, contributions to public charities generally are deductible in an amount equal to the property's fair market value, except for gifts of inventory and other ordinary income property, short-term capital gain property, and tangible personal property the use of which is unrelated to the donee organization's exempt purpose. In addition, under present law, a taxpayer's deductible contributions generally are limited to specified percentages of the taxpayer's contribution base, which generally is the taxpayer's adjusted gross income for a taxable year. The applicable percentage limitations vary depending upon the type of property contributed and the classification of the donee organization. In general, contributions to non-operating private foundations are limited to a smaller percentage of the donor's contribution base (up to 30 percent) than contributions to public charities (up to 50 percent).[98]

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[92] In general, expenditure responsibility requires that a foundation make all reasonable efforts and establish reasonable procedures to ensure that the grant is spent solely for the purpose for which it was made, to obtain reports from the grantee on the expenditure of the grant, and to make reports to the Secretary regarding such expenditures. Sec. 4945(h).

[93] Sec. 4943.

[94] Sec. 4944.

[95] Sec. 170.

[96] Secs. 2055 and 2522.

[97] A special rule in section 170(e)(5) provides that taxpayer are allowed a deduction equal to the fair market value of certain contributions of appreciated, publicly traded stock contributed to a private foundation.

[98] Sec. 170(b).

In general, taxpayers who make contributions and claim a charitable deduction must satisfy recordkeeping and substantiation requirements.[99] The requirements vary depending on the type and value of property contributed. A deduction generally may be denied if the donor fails to satisfy applicable recordkeeping or substantiation requirements.

Intermediate sanctions (excess benefit transaction tax)

The Code imposes excise taxes on excess benefit transactions between disqualified persons and public charities.[100] An excess benefit transaction generally is a transaction in which an economic benefit is provided by a public charity directly or indirectly 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.

For purposes of the excess benefit transaction rules, a disqualified person is any person in a position to exercise substantial influence over the affairs of the public charity at any time in the five-year period ending on the date of the transaction at issue.[101] Persons holding certain powers, responsibilities, or interests (e.g., officers, directors, or trustees) are considered to be in a position to exercise substantial influence over the affairs of the public charity.

An excess benefit transaction tax is imposed on the disqualified person and, in certain cases, on the organization managers, but is not imposed on the public charity. 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 within a specified period. A tax of 10 percent of the excess benefit (not to exceed $10,000 with respect to any excess benefit transaction) is imposed on an organization manager that 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.

Community foundations

Community foundations generally are broadly supported section 501(c)(3) public charities that make grants to other charitable organizations located within a community foundation's particular geographic area. Donors sometimes make contributions to a community foundation through transfers to a separate trust or fund, the assets of which are held and managed by a bank or investment company.

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

[100] Sec. 4958. The excess benefit transaction tax is commonly referred to as "intermediate sanctions," because it imposes penalties generally considered to be less punitive than revocation of the organization's exempt status. The tax also applies to transactions between disqualified persons and social welfare organizations (as described in section 501(c)(4)).

[101] Sec. 4958(f)(1). A disqualified person also includes certain family members of such a person, and certain entities that satisfy a control test with respect to such persons.

Certain community foundations are subject to special rules that permit them to treat the separate funds or trusts maintained by the community foundation as a single entity for tax purposes. This "single entity" status allows the community foundation to be classified as a public charity. One of the requirements that community foundations must meet is that funds maintained by the community foundation may not be subject by the donor to any material restrictions or conditions. The prohibition against material restrictions or conditions is designed to prevent a donor from encumbering a fund in a manner that prevents the community foundation from freely distributing the assets and income from it in furtherance of the community foundation's charitable purposes. Under Treasury regulations, whether a particular restriction or condition placed by the donor on the transfer of assets is material must be determined from all of the facts and circumstances of the transfer. The regulations set out some of the more significant facts and circumstances to be considered in making a determination, including: (1) whether the transferee public charity is the fee owner of the assets received; (2) whether the assets are held and administered by the public charity in a manner consistent with its own exempt purposes; (3) whether the governing body of the public charity has the ultimate authority and control over the assets and the income derived from them; and (4) whether the governing body of the public charity is independent from the donor. The regulations provide several non-adverse factors for determining whether a particular restriction or condition placed by the donor on the transfer of assets is material. In addition, the regulations list numerous factors and subfactors that indicate that the community foundation is prevented from freely and effectively employing the donated assets and the income thereon.

Donor advised funds

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. Although sponsoring charities frequently permit donors (or other 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.

In recent years, a number of financial institutions have formed charitable corporations for the principal purpose of offering donor advised funds, sometimes referred to as "commercial" donor advised funds. In addition, some established charities have begun operating donor advised funds in addition to their primary activities. The IRS has recognized several organizations that sponsor donor advised funds, including "commercial" donor advised funds, as section 501(c)(3) public charities. The term "donor advised fund" is not defined in statute or regulations.

Under the Katrina Emergency Tax Relief Act of 2005, certain of the above-described percent limitations on contributions to public charities are temporarily suspended for purposes of certain "qualified contributions" to public charities. Under the Act, qualified contributions do not include a contribution if the contribution is for establishment of a new, or maintenance in an existing, segregated fund or account with respect to which the donor (or any person appointed or designated by such donor) has, or reasonably expects to have, advisory privileges with respect to distributions or investments by reason of the donor's status as a donor.

Description of Proposal

Definitions

Donor advised fund

The proposal defines a "donor advised fund" as a fund or account that is: (1) separately identified by reference to contributions of a donor or donors[102] (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") or by 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. Notwithstanding the foregoing, the term "donor advised fund" does not include a fund or account from which are made grants to individuals for travel, study, or other similar purposes by such individual, provided that (1) a donor's or donor advisor's advisory privileges are performed exclusively by such donor or donor advisor in their capacity as a member of a committee appointed by the sponsoring organization, (2) no combination of a donor and persons related to or appointed by such donor, control, directly or indirectly, such committee, and (3) all grants from such fund or account satisfy requirements similar to those described in section 4945(g) (concerning grants to individuals by private foundations).

Sponsoring organization

The proposal defines a "sponsoring organization" as an organization that: (1) is described in section 170(c) (other than section 170(c)(1), and without regard to section 170(c)(2)(A)); and (2) maintains one or more donor advised funds.

Donor

Under the proposal, a "donor" is an individual, corporation, partnership, trust, estate, or other person that makes a contribution to a sponsoring organization, which contribution is maintained or intended to be maintained in a donor advised fund.

Investment advisor

[102] The requirement that a donor advised fund be separately identified by reference to contributions of a donor or donors is intended to exclude from the definition of "donor advised fund" certain types of funds or accounts maintained by community foundations and other charities, such as field-of-interest funds and scholarship funds, provided such funds or accounts are not separately identified by reference to contributions of a donor or donors.

Under the proposal, the term "investment advisor" means, with respect to any sponsoring organization, any person (other than an employee of the sponsoring organization) compensated by the sponsoring organization for managing the investment of, or providing investment advice with respect to, assets maintained in donor advised funds owned by the sponsoring organization.

Deductibility of contributions to a sponsoring organization for maintenance in a donor advised fund

Contributions to certain sponsoring organizations for maintenance in a donor advised fund not eligible for a charitable deduction

Under the proposal, contributions to a sponsoring organization for maintenance in a donor advised fund will not be eligible for a charitable deduction for income tax purposes if the sponsoring organization is an organization described in sections 170(c)(3), 170(c)(4), 170(c)(5), or 509(a)(3); for gift tax purposes if the sponsoring organization is an organization described in sections 2522(a)(3) or 2522(a)(4); or for estate tax purposes if the sponsoring organization is an organization described in sections2055(a)(3) or 2055(a)(4).

Additional substantiation requirements

In addition to satisfying present-law 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 written acknowledgment from the sponsoring organization providing that the sponsoring organization has exclusive legal control over the assets contributed.

Minimum distributions

Aggregate payout requirement

Under the proposal, a sponsoring organization is required, before the end of a taxable year of the organization, to make qualifying distributions, from the assets of donor advised funds maintained by the organization, equivalent to five percent of the aggregate asset value of donor advised funds maintained by the sponsoring organization in the immediately preceding taxable year. The proposal excludes from the computation of the required distributable amount for a taxable year the assets of donor advised funds that have been in existence for less than one full year as of the end of the immediately preceding taxable year.[103] The aggregate payout rule does

[103] Assume, for example, that a sponsoring organization ("S") initially maintained 10 donor advised funds, each established in Year 1. In Year 3, a new donor advised fund is established. For purposes of determining S's aggregate payout requirement for Year 4, the donor advised fund established in Year 3 is excluded, because it was in existence for less than a year as of the end of Year 3. For these purposes, a donor advised fund is deemed created when the account is first established (rather than when a donor achieves the minimum account balance required under the sponsoring organization's rules to begin grantmaking, if later).

not apply in the case of a donor advised fund maintained by a private foundation that is subject to the requirements of section 4942.

Account-level activity requirement

General rule

Under the proposal, each donor advised fund maintained by a sponsoring organization must distribute at least a certain amount in qualifying distributions during any applicable three-year period. If such amount is not distributed from a donor advised fund during such period, the proposal requires that the sponsoring organization distribute such amount from such account as qualifying distributions within 120 days. The required distributable amount is the greater of (1) $250 or (2) two and one-half percent of the sponsoring organization's average required minimum initial contribution amount for such period[104] (or average required minimum balance, if greater) for the type of donor[105] at issue. An applicable three-year period must correspond with three consecutive taxable years of the sponsoring organization. The first applicable three-year period for a donor advised fund begins only after the fund has been in existence for one full year.[106]

Account-level distribution requirement for accounts that hold illiquid assets

If, as of the end of any taxable year of the sponsoring organization, a donor advised fund holds assets other than cash and marketable securities (i.e., "illiquid assets") that equal more than 10 percent of the total value of assets in the account (determined using the following valuation procedures), the donor advised fund must distribute as qualifying distributions within 12 months of the close of such taxable year at least five percent of the value of the assets in the donor advised fund as of the end of such year (the "illiquid asset payout requirement"). If such amount is not distributed from a donor advised fund by such time, the proposal requires that the sponsoring organization distribute such amount from such fund as qualifying distributions within 120 days.

If a donor advised fund holds illiquid assets representing 10 percent of the fund's value as of the end of a taxable year of the sponsoring organization, but did not hold such assets for a

[104] For purposes of the proposal, the required minimum initial contribution amount is the minimum contribution amount required by the sponsoring organization in order to open a donor advised fund.

[105] Under some circumstances, for example, a sponsoring organization may establish higher minimum initial contribution amounts for corporate donors than for individual donors.

[106] Applicable three-year periods for any donor advised fund run consecutively, such that the second three-year period begins immediately after the first three-year period ends. For example, assume donor advised fund X is established on March 30 of Year 1, and the sponsoring organization's taxable year corresponds to the calendar year. As of the end of Year 1, X has not been in existence for one full year; therefore, X's first applicable three-year period does not begin in Year 2. Instead, the first such period begins on January 1 of Year 3 and runs through December 31 of Year 5. X's second applicable three-year period begins on January 1 of Year 6 and ends on December 31 of Year 8.

period of 12 months, the fund is treated as holding only cash and marketable securities for purposes of the illiquid asset payout requirement for such year. If, however, the donor advised fund holds illiquid assets at the beginning of a taxable year of a sponsoring organization and such assets are during such year exchanged for illiquid assets that are held at the end of such year, the donor advised fund is deemed to have held illiquid assets for the entire taxable year of the sponsoring organization, and the account is subject to the illiquid asset payout requirement. The Secretary is authorized to promulgate anti-abuse rules to prevent the circumvention of the proposal through transactions designed to avoid application of illiquid asset payout requirement, such as through exchanges of illiquid assets for other assets.

Qualifying distributions

For purposes of all of the distribution requirements described in the proposal, qualifying distributions are amounts paid to organizations described in section 170(b)(1)(A) (other than supporting organizations described in section 509(a)(3) or a sponsoring organization if the amount is for maintenance in a donor advised fund). Distributions to the sponsoring organization are qualifying distributions if the distribution is designated for use in connection with a charitable program of the sponsoring organization (e.g., if funds are transferred to a scholarship fund (that does not meet the definition of donor advised fund because, for example, the scholarship fund is not separately identified by reference to donors) for the awarding of scholarships consistent with the sponsoring organization's exempt purposes).[107] Amounts permanently set aside for purposes, and under procedures similar to those, described in section 4942(g) will be treated as qualifying distributions.

Valuation

Special valuation rules apply for purposes of determining the required distributable amount for a taxable year under the aggregate payout requirement and the account-level payout requirement applicable to accounts that hold illiquid assets. For such purposes, the fair market values of cash and of securities for which market quotations are readily available are determined on a monthly basis. All other assets ("illiquid assets") transferred by a donor to a sponsoring organization for maintenance in a donor advised fund are valued at the sum of (1) the value claimed by the donor for purposes of determining the donor's charitable deduction for the contribution of such assets to the sponsoring organization,[108] and (2) an assumed annual rate of return of five percent. If a donor advised fund invests in illiquid assets, such assets are valued at the sum of (1) the purchase price paid for the assets, and (2) an assumed annual rate of return of five percent. The Secretary of the Treasury is authorized to specify the requirements for making such computations. Under the proposal, the Secretary of the Treasury is also authorized to

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[107] Neither the payment of administrative expenses, nor distributions to the sponsoring organization for administrative expenses, qualifies for purposes of the aggregate payout requirement.

[108] The donor is required to report to the sponsoring organization the value of the asset claimed by the donor for charitable deduction purposes either by supplying to the sponsoring organization a copy of the donor's completed Form 8283 related to the deduction (if applicable) or by following any alternative procedures specified by the Secretary in regulations.

promulgate rules permitting adjustments in the value of an illiquid asset in situations where the asset declines significantly in value following a contribution or purchase of the asset.

Treatment of qualifying distributions

Distributions made in satisfaction of any of the above-described distribution requirements are counted for purposes of all payout requirements described in the proposal. For purposes of any distribution requirement described in this proposal, the taxpayer may designate a qualifying distribution as being made out of the undistributed amount remaining from any prior taxable year or as being made in satisfaction of the distribution requirement for the current taxable year. Amounts distributed in excess of the undistributed amount for the current year and all previous taxable years may be carried forward for up to five taxable years following the taxable year in which the excess payment is made.

Penalties for failure to distribute

In the event of a failure to distribute the required amount in connection with any of the above-described distribution requirements within the prescribed time period, the proposal imposes excise taxes similar to the private foundation excise taxes under section 4942. Specifically, a first-tier excise tax equal to 30 percent[109] of the undistributed amount is imposed. The first-tier tax may be abated if the failure was due to reasonable cause and not to willful neglect. If the failure is not corrected within the taxable period (as defined in existing section 4942(j)(1)), a second-tier tax equal to 100 percent of the undistributed amount is imposed.

Prohibited transactions and sanctions

The proposal provides that donors, donor advisors, and investment advisors to donor advised funds (as well as persons related to the foregoing persons[110]) automatically are treated as disqualified persons with respect to the sponsoring organization under section 4958 or under section 4946(a).

The proposal also provides that distributions from a donor advised fund to a person that with respect to such fund is a donor, donor adviser, or a person related to a donor or donor adviser (though not an investment advisor) automatically will be treated as an excess benefit transaction under section 4958, with the entire amount paid to the disqualified person being deemed the amount of the excess benefit. (The section 4958 tax on organization managers also would apply.) This rule applies regardless of whether the sponsoring organization is a public

[109] Under a separate proposal, the first-tier tax under section 4942 would be increased from 15 percent to 30 percent.

[110] For purposes of the proposal, a person is treated as related to another person if (1) 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).

charity or a private foundation and regardless of whether, but for this rule, the transaction would have been subject to the section 4941 self-dealing rules.[111]

Any amount repaid as a result of correcting such an excess benefit transaction shall not be held in or credited to any donor advised fund with respect to which the donor or donor advisor has or reasonably expects to have advisory privileges. The Secretary is authorized to issue regulations specifying how such payments may be made.

Under the proposal, distributions from a donor advised fund (as opposed to a sponsoring organization's non donor advised funds or accounts) to any person other than the sponsoring organization's non donor advised funds or accounts or organizations described in section 170(b)(1)(A)[112] (other than supporting organizations described in clause (viii) or sponsoring organizations for maintenance in a donor advised fund) are prohibited.[113] The proposal provides for a penalty in the event a distribution is made from a donor advised fund to an ineligible person, such as a private non-operating foundation or a supporting organization. In the event of such a distribution, an excise tax equal to 20 percent of the amount of the distribution is imposed against any donor or donor advisor who advised that such distribution be made. 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. The taxes described in this paragraph are subject to abatement.

Under the proposal, if a donor, a donor advisor, or a person related to a donor or donor advisor of a donor advised fund receives, directly or indirectly, a benefit as a result of a distribution from such donor advised fund, and such benefit is more than incidental, excise taxes are imposed against any donor or donor advisor who recommended the distribution, and against the recipient of the benefit. The amount of the tax is determined by multiplying the rate of the initial tax imposed against a disqualified person under section 4958 by the amount of the distribution that gave rise to the more-than-incidental benefit. Persons subject to the tax are jointly and severally liable for the entire amount of the tax. In addition, if a manager of the

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[111] This rule includes any distribution to a donor, donor advisor, or a related person, whether in the form of a grant, loan, compensation arrangement, expense reimbursement, or other payment. If the excess benefit results from the payment of compensation, the entire amount paid as compensation will be deemed the amount of the excess benefit, whether the sponsoring organization is a private foundation or a public charity.

[112] By requiring that distributions from a donor advised fund be made only to certain entities, the proposal prohibits distributions from a donor advised fund to a donor or donor advisor (or person related to a donor or donor advisor), whether as compensation, loans, or reimbursement of expenses.

[113] Under the proposal, distributions from donor advised funds to individuals are prohibited. However, sponsoring organizations may make grants to individuals from amounts not held in donor advised funds and may establish scholarship funds that are not donor advised funds. A donor may choose to make a contribution directly to such a scholarship fund (or advise that a donor advised fund make a distribution to such a scholarship fund).

sponsoring organization (defined in a manner similar to the term “foundation manager” under section 4945) who participated in the approval of the distribution knew at the time of such participation 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 of a donor advised fund, the manager also is subject to an excise tax, calculated by multiplying the rate of the initial tax specified under section 4958 with respect to organization managers by the amount of the distribution that gave rise to the more-than-incidental benefit. The taxes described in this paragraph are subject to abatement if it is established that the taxable event was due to reasonable cause and not to willful neglect.

Reporting and disclosure

The proposal requires each sponsoring organization to disclose on its information return: (1) the total number of donor advised funds it owns; (2) the aggregate value of assets held in those funds at the end of the organization’s taxable year; and (3) the aggregate contributions to and grants made from those funds during the year. The statute of limitations for assessing any tax arising under the proposal in any year with respect to which the required information has not been provided shall not expire before three years after the date on which the required information is disclosed to the IRS.

In addition, when seeking recognition of its tax-exempt status, a sponsoring organization must disclose whether it intends to maintain donor advised funds and must provide detailed information regarding its planned operation of such funds, including, for example, a description of procedures it intends to use to: (1) communicate to donors and donor advisors that assets held in donor advised funds are the property of the sponsoring organization; and (2) ensure that distributions from donor advised funds do not result in more than incidental private benefit to any person.

Effective Date

The proposal is generally applicable on the date of enactment. Payout requirements are effective for taxable years beginning after the date of enactment. Information return requirements are effective for taxable years ending after the date of enactment. The requirements concerning disclosures on an organization’s application for tax exemption are effective for organizations applying for recognition of exempt status after the date of enactment. Requirements relating to charitable contributions to donor advised funds are effective contributions made after 180 days from the date of enactment.

12. Improve accountability of supporting organizations

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.[114] 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) the net earnings of the organization may not inure to the benefit of any person in a position to influence the activities of the organization; (2) the organization must operate to provide a public benefit, not a private benefit;[115] (3) the organization may not be operated primarily to conduct an unrelated trade or business;[116] (4) the organization may not engage in substantial legislative lobbying; and (5) the organization may not participate or intervene in any political campaign.

Section 501(c)(3) organizations (with certain exceptions) are required to seek formal recognition of tax-exempt status by filing an application with the IRS (Form 1023). In response to the application, the IRS issues a determination letter or ruling either recognizing the applicant as tax-exempt or not.

In general, organizations exempt from Federal income tax under section 501(a) are required to file an annual information return with the IRS.[117] Under present law, the information return requirement does not apply to several categories of exempt organizations. Organizations exempt from the filing requirement include organizations (other than private foundations), the gross receipts of which in each taxable year normally are not more than $25,000.[118]

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[114] 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).

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

[116] 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.

[117] Sec. 6033(a)(1).

[118] Sec. 6033(a)(2); Treas. Reg. sec. 1.6033-2(a)(2)(i); Treas. Reg. sec. 1.6033-2(g)(1). Sec. 6033(a)(2)(A)(ii) provides a $5,000 annual gross receipts exception from the annual reporting requirements for certain exempt organizations. In Announcement 82-88, 1982-25 I.R.B. 23, the IRS exercised its discretionary authority under section 6033 to increase the gross receipts exception to $25,000, and enlarge the category of exempt organizations that are not required to file Form 990.

Classification of section 501(c)(3) organizations

In general

Section 501(c)(3) organizations are classified either as "public charities" or "private foundations."[119] 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.[120] For example, the Code imposes excise taxes on acts of "self-dealing" between disqualified persons (generally, an enumerated class of foundation insiders[121]) and a private foundation. Acts of self-dealing include, for example, sales or exchanges, or leasing, of property; lending of money; or the furnishing of goods, services, or facilities between a disqualified person and a private foundation.[122] In addition, private non-operating foundations are required to pay out a minimum amount each year as qualifying distributions. 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.[123] Certain expenditures of private foundations are also subject to tax.[124] In general, taxable expenditures are expenditures: (1) for lobbying; (2) to influence the outcome of a public election or carry on a voter registration drive (unless certain requirements are met); (3) as a grant to an individual for travel, study, or similar purposes unless made pursuant to procedures approved by the Secretary; (4) as a grant to an organization that is not a public charity or exempt

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[119] 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.

[120] Secs. 4940 - 4945.

[121] See sec. 4946(a).

[122] Sec. 4941.

[123] Sec. 4942(g)(1)(A). 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. Sec. 4942(g)(1)(B) and 4942(g)(2).

[124] Sec. 4945. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

operating foundation unless the foundation exercises expenditure responsibility[125] with respect to the grant; or (5) for any non-charitable purpose. Additional excise taxes may apply in the event a private foundation holds certain business interests ("excess business holdings")[126] or makes an investment that jeopardizes the foundation's exempt purposes.[127]

Public charities also enjoy certain advantages over private foundations regarding the deductibility of contributions. For example, contributions of appreciated capital gain property to a private foundation generally are deductible only to the extent of the donor's cost basis.[128] In contrast, contributions to public charities generally are deductible in an amount equal to the property's fair market value, except for gifts of inventory and other ordinary income property, short-term capital gain property, and tangible personal property the use of which is unrelated to the donee organization's exempt purpose. In addition, under present law, a taxpayer's deductible contributions generally are limited to specified percentages of the taxpayer's contribution base, which generally is the taxpayer's adjusted gross income for a taxable year. The applicable percentage limitations vary depending upon the type of property contributed and the classification of the donee organization. In general, contributions to non-operating private foundations are limited to a smaller percentage of the donor's contribution base (up to 30 percent) than contributions to public charities (up to 50 percent).[129]

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.[130] 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"[131] (the "organizational and

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[125] In general, expenditure responsibility requires that a foundation make all reasonable efforts and establish reasonable procedures to ensure that the grant is spent solely for the purpose for which it was made, to obtain reports from the grantee on the expenditure of the grant, and to make reports to the Secretary regarding such expenditures. Sec. 4945(h).

[126] Sec. 4943.

[127] Sec. 4944.

[128] A special rule in section 170(e)(5) provides that taxpayer are allowed a deduction equal to the fair market value of certain contributions of appreciated, publicly traded stock contributed to a private foundation.

[129] Sec. 170(b).

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

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

operational tests");[132] (2) it must be operated, supervised, or controlled by or in connection with one or more publicly supported organizations (the "relationship test");[133] 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").[134]

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).[135]

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.[136] 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 the governing body, members of the governing body, officers acting in their official capacity, or the membership of one or more publicly supported organizations.[137]

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

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

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

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

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

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

[137] Id.

organizations.[138] 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.[139]

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 meets both a "responsiveness test" and an "integral part test."[140]

In general, the responsiveness test requires that the Type III supporting organization be responsive to the needs or demands of the publicly supported organizations. The responsiveness test may be satisfied in one of two ways.[141] First, the supporting organization may demonstrate 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 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; 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.[142] Alternatively, the responsiveness test may be satisfied if the supporting organization is a charitable trust under state law, each specified supported organization is a named beneficiary under the trust's governing instrument, and the beneficiary organization has the power to enforce the trust and compel an accounting under state law.[143]

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

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

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

[141] 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)(1)(ii).

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

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

In general, the integral part test requires that the Type III supporting organization maintain significant involvement in the operations of one or more publicly supported organizations, and that such publicly supported organizations are in turn dependent upon the supporting organization for the type of support which it provides. There are two alternative methods for satisfying the integral part test. The first alternative is to establish that (1) the activities engaged in for or on behalf of the publicly supported organization are activities to perform the functions of, or carry out the purposes of, such organizations; and (2) these activities, but for the involvement of the supporting organization, normally would be engaged in by the publicly supported organizations themselves.[144] The second method for satisfying the integral part test is to establish that: (1) the supporting organization pays substantially all of its income to or for the use of one or more publicly supported organizations;[145] (2) the amount of support received by one or more of the publicly supported organizations is sufficient to insure the attentiveness of the organization or organizations to the operations of the supporting organization (this is known as the "attentiveness requirement");[146] and (3) a significant amount of the total support of the supporting organization goes to those publicly supported organizations that meet the "attentiveness requirement."[147]

Intermediate sanctions (excess benefit transaction tax)

The Code imposes excise taxes on excess benefit transactions between disqualified persons and public charities.[148] An excess benefit transaction generally is a transaction in which an economic benefit is provided by a public charity directly or indirectly 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.

For purposes of the excess benefit transaction rules, a disqualified person is any person in a position to exercise substantial influence over the affairs of the public charity at any time in the

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

[145] For this purpose, the IRS has defined the term "substantially all" of an organization's income to mean 85 percent or more. Rev. Rul. 76-208, 1976-1 C.B. 161.

[146] Although the regulations do not specify the requisite level of support in numerical or percentage terms, the IRS has suggested that grants that represent less than 10 percent of the beneficiary's support likely would be viewed as insufficient to ensure attentiveness. Gen. Couns. Mem. 36379 (August 15, 1975). As an alternative to satisfying the attentiveness standard by the foregoing method, a supporting organization may demonstrate attentiveness by showing that, in order to avoid the interruption of the carrying on of a particular function or activity, the beneficiary organization will be sufficiently attentive to the operations of the supporting organization. Treas. Reg. sec. 1.509(a)-4(i)(3)(iii)(b).

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

[148] Sec. 4958. The excess benefit transaction tax is commonly referred to as "intermediate sanctions," because it imposes penalties generally considered to be less punitive than revocation of the organization's exempt status. The tax also applies to transactions between disqualified persons and social welfare organizations (as described in section 501(c)(4)).

five-year period ending on the date of the transaction at issue.[149] Persons holding certain powers, responsibilities, or interests (e.g., officers, directors, or trustees) are considered to be in a position to exercise substantial influence over the affairs of the public charity.

An excess benefit transaction tax is imposed on the disqualified person and, in certain cases, on the organization managers, but is not imposed on the public charity. 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 within a specified period. A tax of 10 percent of the excess benefit (not to exceed $10,000 with respect to any excess benefit transaction) is imposed on an organization manager that 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.

Description of Proposal

Proposals relating to all (Type I, Type II, and Type III) supporting organizations

Prohibited transactions

Supporting organizations (Type I, Type II, or Type III) are prohibited from making grants, loans, compensation, or other similar payments to a substantial contributor (or person related to the substantial contributor)[150] of the supporting organization. If a prohibited payment is made, the substantial contributor is treated as a disqualified person and the transaction is treated as an excess benefit transaction with the entire amount of the payment treated as the excess benefit. The prohibition does not apply if the substantial contributor is a public charity (other than a supporting organization). A substantial contributor is similar to a person as described in section 507(d)(2).

Loans by any supporting organization (Type I, Type II, or Type III) to a disqualified person (as defined in section 4958) of the supporting organization are prohibited. With respect to any such loan, the loan is treated as an excess benefit transaction and the entire amount of the loan is treated as an excess benefit. For this purpose, a disqualified person does not include a public charity (other than a supporting organization).

Disclosure requirements

All supporting organizations are required to file an annual information return (Form 990 series) with the Secretary, regardless of the organization's gross receipts. A supporting organization must indicate on such annual information return (and on the application for tax-

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[149] Sec. 4958(f)(1). A disqualified person also includes certain family members of such a person, and certain entities that satisfy a control test with respect to such persons.

[150] For purposes of this proposal, 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 section 4958(f)(1)(B) or section 4958(f)(1)(C).

exempt status) whether it is a Type I, Type II, or Type III supporting organization. A supported organization must identify on its Form 990 filed with the Secretary the organizations with respect to which it is a supported organization.

Supporting organizations must demonstrate annually that the organization is not controlled directly or indirectly by one or more disqualified persons (other than foundation managers and other than one or more publicly supported organizations) through a certification on the annual information return that the majority of the organization's governing body is comprised of individuals who were selected based on their special knowledge or expertise in the particular field or discipline in which the supporting organization is operating, or because they represent the particular community that is served by the supported public charities, and who have no family, personal, or business relationship to any of the organization's disqualified persons.

Excess business holdings

The excess business holdings rules of section 4943 are applied to supporting organizations. In applying such rules, the term disqualified person has the meaning provided in section 4958, and also includes substantial contributors as described in section 507(d)(2) and persons related to substantial contributors and persons similar to those described in section 4943(a)(1)(H). The Secretary has the authority not to impose the excess business holding rules if the organization establishes to the satisfaction of the Secretary that the excess holdings are consistent with the exempt purposes of the organization.

Proposals that apply only to Type III supporting organizations

Modify payout requirement of Type III supporting organizations

A Type III supporting organization must pay each taxable year, to or for the use of one or more public charities described in section 509(a)(1) or 509(a)(2), the sum of (1) the greater of (i) 85 percent of its income or (ii) five percent of the aggregate fair market value of all of the assets of the organization other than assets that are used (or held for use) directly in supporting the charitable programs of the supporting organization or one or more supported organizations, determined as of the last day of the taxable year, and (2) any amount received or accrued in such year as repayments of amounts that were taken into account as support provided by the supporting organization in prior years. In general, the distributable amount for a taxable year must be distributed before the first day of the second taxable year following such year, under rules similar to the distribution rules under section 4942. For purposes of any distribution requirement described in this proposal, the taxpayer may designate a qualifying distribution as being made out of the undistributed amount remaining from any prior taxable year or as being made in satisfaction of the distribution requirement for the current taxable year. Amounts distributed in excess of the undistributed amount for the current year and all previous taxable years may be carried forward for up to five taxable years following the taxable year in which the excess payment is made. [151]

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[151] Under present law, certain Type III organizations are required to pay out substantially all of their income to section 509(a)(1) or 509(a)(2) organizations. Such Type III organizations also must

A supporting organization's administrative and operating expenses do not count as expenses to or for the use of a supported organization. The holding of assets for investment purposes, or to operate a trade or business, is not considered a use or holding for use directly to support a supported organization's charitable programs. The Secretary may provide guidance as to types of uses of assets that are considered to be directly in support of a supported organization's charitable programs similar to guidance provided under Treasury Regulation section 53.4942(a)-2(c)(3)(i).

An organization that fails to meet the payout requirement is subject to an initial tax of 30 percent of the unpaid amount, increased to 100 percent of the unpaid amount if the payout requirement is not met by the earlier of the date of mailing of a notice of deficiency with respect to the initial tax or the date on which the initial tax is assessed.

Organizational and operational requirements

A Type III supporting organization may not support more than five organizations, may not support an organization that is not organized in the United States,[152] and may not be a donor with respect to a donor advised fund. However, a Type III supporting organization may provide support to a sponsoring organization of a donor advised fund to the extent the support is not for maintenance in a donor advised fund.

Relationship to supported organization(s)

A Type III supporting organization must, as part of its exemption application (Form 1023) attach a letter from each organization that is designated by the supporting organization as receiving its support.

On the annual information return filed by a Type III supporting organization, the organization must indicate that it has obtained letters from organizations that received its support. All such letters must be signed by a senior officer or a member of the Board of the supported organization and must show (1) that the supported organization agrees to be supported by the supporting organization, (2) the type of support provided or to be provided, and (3) how such support furthers the supported organization's charitable purposes.

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establish that a substantial amount of the total support provided must go to organizations that meet the present law "attentiveness" requirement. The proposal does not change this requirement but does extend it to Type III supporting organizations that under present law are not subject to a payout requirement (by virtue of satisfying Treasury Regulation section 1.509(a)-4(i)(3)(ii)).

[152] U.S. charities established principally to provide financial and other assistance to a foreign charity, sometimes referred to as "friends of" organizations, may not be established as supporting organizations under the proposal. Such organizations may continue to obtain public charity status, however, by virtue of demonstrating broad public support (as described in sections 509(a)(1) and 509(a)(2)).

A Type III supporting organization must apprise each organization it supports of information regarding the supporting organization in order to help ensure the supporting organization's responsiveness. Such a showing could be satisfied, for example, through provision of documentation such as a copy of the supporting organization's governing documents, any changes made to the governing documents, the organization's annual information return filed with the Secretary (Form 990 series), any tax return (Form 990-T) filed with the Secretary, and an annual report (including a description of all of the support provided by the supporting organization, how such support was calculated, and a projection of the next year's support). Failure to make a sufficient showing is a factor in determining whether the responsiveness test of present law is met.

A type III supporting organization that is organized as a trust must, in addition to present law requirements, establish to the satisfaction of the Secretary, that it has a close and continuous relationship with the supported organization such that the trust is responsive to the needs or demands of the supported organization.

Other provisions

If a Type I or Type III supporting organization supports an organization that is controlled, directly or indirectly, by a donor (other than a public charity that is not a supporting organization) of the supporting organization or person related to the donor (or any combination of such persons), then the supporting organization is treated as a private foundation for all purposes until such time as the organization can demonstrate to the satisfaction of the Secretary that it qualifies as a public charity other than as a supporting organization.

For purposes of the excess benefit transaction rules, a disqualified person of a supporting organization is treated as a disqualified person of the supported organization.

A non-operating private foundation may not count as a qualifying distribution under section 4942 any amount paid to a supporting organization. In addition, any amount paid to a supporting organization shall be treated as a taxable expenditure under section 4945 unless the private foundation exercises expenditure responsibility with respect to the grant.

Effective Date

The proposal generally is effective on the date of enactment. The limitation on supporting no more than five organizations is effective for organizations established on or after the date of enactment (but organizations established before the date of enactment may not increase the number of organizations supported above the number of organizations supported on the date of enactment, and may not add new supported organizations as beneficiaries unless no more than five organizations are supported by the supporting organization following such addition). The distribution requirements are effective for taxable years beginning after the date of enactment. The prohibited transaction rules are effective for transactions occurring after the date of enactment. The excess business holdings requirements generally are effective for taxable years beginning after the date of enactment, but transition rules similar to the rules under sections 4943(c)(4) and 4943(c)(5) shall apply. The limitations on charitable contributions of capital gain property are effective for taxable years beginning after the date of enactment. The return requirements are effective for returns filed for taxable years ending after the date of enactment. Making a showing to a supported organization in satisfaction of the responsiveness test is effective for taxable years beginning after the date of enactment.

13. Reform rules for charitable contributions of easements on buildings in registered historic districts

Present Law

In general

Present law provides special rules that apply to charitable deductions of qualified conservation contributions, which include conservation easements and façade easements.[153] Qualified conservation contributions are not subject to the "partial interest" rule, which generally bars deductions for charitable contributions of partial interests in property.[154] Accordingly, qualified conservation contributions are contributions of partial interests that are eligible for a fair market value charitable deduction.

A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. A qualified real property interest is defined as: (1) the entire interest of the donor other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use that may be made of the real property.[155] Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations.

Conservation purposes include: (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy; and (4) the preservation of an historically important land area or a certified historic structure.[156]

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[153] Sec. 170(h).

[154] Sec. 170(f)(3).

[155] Charitable contributions of interests that constitute the taxpayer's entire interest in the property are not regarded as qualified real property interests within the meaning of section 170(h), but instead are subject to the general rules applicable to charitable contributions of entire interests of the taxpayer (i.e., generally are deductible at fair market value, without regard to satisfaction of the requirements of section 170(h)).

[156] Sec. 170(h)(4)(A).

In general, no deduction is available if the property may be put to a use that is inconsistent with the conservation purpose of the gift.[157] A contribution is not deductible if it accomplishes a permitted conservation purpose while also destroying other significant conservation interests.[158]

Taxpayers are required to obtain a qualified appraisal for donated property with a value of $5,000 or more, and to attach an appraisal summary to the tax return.[159] Under Treasury regulations, a qualified appraisal means an appraisal document that, among other things: (1) relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property and not later than the due date (including extensions) of the return on which a deduction is first claimed under section 170;[160] (2) is prepared, signed, and dated by a qualified appraiser; (3) includes (a) a description of the property appraised; (b) the fair market value of such property on the date of contribution and the specific basis for the valuation; (c) a statement that such appraisal was prepared for income tax purposes; (d) the qualifications of the qualified appraiser; and (e) the signature and taxpayer identification number of such appraiser; and (4) does not involve an appraisal fee that violates certain prescribed rules.[161]

Valuation

The value of a conservation restriction granted in perpetuity generally is determined under the "before and after approach." Such approach provides that the fair market value of the restriction is equal to the difference (if any) between the fair market value of the property the restriction encumbers before the restriction is granted and the fair market value of the encumbered property after the restriction is granted.[162]

If the granting of a perpetual restriction has the effect of increasing the value of any other property owned by the donor or a related person, the amount of the charitable deduction for the conservation contribution is to be reduced by the amount of the increase in the value of the other property.[163] In addition, the donor is to reduce the amount of the charitable deduction by the amount of financial or economic benefits that the donor or a related person receives or can reasonably be expected to receive as a result of the contribution.[164] If such benefits are greater

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[157] Treas. Reg. sec. 1.170A-14(e)(2).

[158] Treas. Reg. sec. 1.170A-14(e)(2).

[159] Sec. 170(f)(11)(C).

[160] In the case of a deduction first claimed or reported on an amended return, the deadline is the date on which the amended return is filed.

[161] Treas. Reg. sec. 1.170A-13(c)(3).

[162] Treas. Reg. sec. 1.170A-14(h)(3).

[163] Treas. Reg. sec. 1.170A-14(h)(3)(i).

[164] *Id.*

than those that will inure to the general public from the transfer, no deduction is allowed.[165] In those instances where the grant of a conservation restriction has no material effect on the value of the property, or serves to enhance, rather than reduce, the value of the property, no deduction is allowed.[166]

Preservation of a certified historic structure

A certified historic structure means any building, structure, or land which is (i) listed in the National Register, or (ii) located in a registered historic district (as defined in section 47(c)(3)(B)) and is certified by the Secretary of the Interior to the Secretary of the Treasury as being of historic significance to the district.[167] For this purpose, a structure means any structure, whether or not it is depreciable, and, accordingly, easements on private residences may qualify.[168] If restrictions to preserve a building or land area within a registered historic district permit future development on the site, a deduction will be allowed only if the terms of the restrictions require that such development conform with appropriate local, State, or Federal standards for construction or rehabilitation within the district.[169]

The IRS and the courts have held that a facade easement may constitute a qualifying conservation contribution.[170] In general, a facade easement is a restriction the purpose of which is to preserve certain architectural, historic, and cultural features of the facade, or front, of a building. The terms of a facade easement might permit the property owner to make alterations to the facade of the structure if the owner obtains consent from the qualified organization that holds the easement.

Description of Proposal

The proposal revises the rules for qualified conservation contributions with respect to property located in a registered historic district. Under the proposal, a charitable deduction is not allowable with respect to a structure or land area located in such a district. A charitable deduction is allowable with respect to buildings (as is the case under present law) but the qualified real property interest that relates to the exterior of the building must preserve the entire

[165] *Id*.

[166] Treas. Reg. sec. 1.170A-14(h)(3)(ii).

[167] Sec. 170(h)(4)(B).

[168] Treas. Reg. sec. 1.170A-14(d)(5)(iii).

[169] Treas. Reg. sec. 1.170A-14(d)(5)(i).

[170] *Hillborn v. Commissioner*, 85 T.C. 677 (1985) (holding the fair market value of a facade donation generally is determined by applying the "before and after" valuation approach); *Richmond v. U.S.*, 699 F. Supp. 578 (E.D. La. 1988); Priv. Ltr. Rul. 199933029 (May 24, 1999) (ruling that a preservation and conservation easement relating to the facade and certain interior portions of a fraternity house was a qualified conservation contribution).

exterior of the building, including the space above the building, the sides, the rear, and the front of the building, and the building must be habitable. In addition, such qualified real property interest must provide that no portion of the exterior of the building may be changed or altered in a manner inconsistent with the historical character of such exterior. Taxpayers must obtain a qualified appraisal of the qualified real property interest (irrespective of the claimed value of such interest) and attach the appraisal with the taxpayer's return. Appraisals must include photographs of the entire exterior of the building and descriptions of all current restrictions on development of the building, including zoning laws, ordinances, neighborhood association rules, restrictive covenants, and other similar restrictions. Failure to obtain and attach an appraisal or to include the required information in the appraisal results in disallowance of the deduction.

Qualified conservation contributions with respect to a building located in a registered historic district are not allowed unless the donee organization has been accredited by the National Trust for Historic Preservation.[171] In developing an accreditation program, the National Trust for Historic Preservation shall consult with the Internal Revenue Service, the National Park Service, and State Historic Preservation Officers as described in 16. U.S.C. sec 470a(b). Such accreditation program is required to develop best practices for donee organizations, such as establishing standards for regular monitoring of interests held by an organization, maintenance of sufficient resources to monitor and enforce interests held by an organization, and conflicts of interest policies to be followed in connection with the solicitation and administration of contributions. Accreditation must be obtained at least once every five years, and an organization must show that its current resources are sufficient to monitor and enforce existing interests held by the organization, that it has effectively monitored and enforced such interests, that the organization either has sufficient resources to monitor new interests or can demonstrate that such resources will be available for monitoring and enforcing new interests, that the organization follows a suitable conflict of interest policy with respect to solicitation and administration of contributions, that the organization does not engage in deceptive or misleading promotional practices, and that the organization has a policy to ensure that restrictions held by the organization will be protected in perpetuity in the event the organization can no longer sufficiently monitor and enforce the restriction. Accreditation standards and the procedure for accreditation must be complete by January 1, 2007. In addition, under the proposal, a governmental unit (as described in section 170(b)(1)(A)(v)) is no longer an eligible donee for such contributions.

Taxpayers claiming a deduction for a qualified conservation contribution with respect to the exterior of a building located in a registered historic district are subject to a limitation on the amount allowed as a deduction for the qualified conservation contribution equal to the greater of three percent of the fair market value of the underlying property or $10,000. As an alternative to being subject to such limitation, a taxpayer may pay a $500 fee to the Internal Revenue Service. Amounts paid are required to be dedicated to Internal Revenue Service enforcement of qualified conservation contributions.

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[171] The National Trust for Historic Preservation is an organization chartered by Congress pursuant to 16. U.S.C. secs. 468-468d.

Effective Date

The proposal generally is effective for contributions made after the date of enactment, except that the requirement that a qualified real property interest be with respect to the entire exterior of the building is effective for contributions made after December 16, 2004. The limitation on the amount that may be deducted and the filing fee is effective for contributions made 180 days after the date of enactment. The requirement that a donee organization be accredited is effective on January 1, 2008.

14. Reform rules relating to charitable contributions of taxidermy and recapture tax benefit on property not used for an exempt use

Present Law

Deductibility of charitable contributions

In general

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 501(c)(3) or to a Federal, State, or local governmental entity.[172] The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced or limited depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.[173] In general, more generous charitable contribution deduction rules apply to gifts made to public charities than to gifts made to private foundations. Within certain limitations, donors also are entitled to deduct their contributions to section 501(c)(3) organizations for Federal estate and gift tax purposes. By contrast, contributions to nongovernmental, non-charitable tax-exempt organizations generally are not deductible by the donor,[174] though such organizations are eligible for the exemption from Federal income tax with respect to such donations.

Contributions of property

The amount of the deduction for charitable contributions of capital gain property generally equals the fair market value of the contributed property on the date of the contribution. Capital gain property means any capital asset, or property used in the taxpayer's trade or business, the sale of which at its fair market value, at the time of contribution, would have

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[172] The deduction also is allowed for purposes of calculating alternative minimum taxable income.

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

[174] Exceptions to the general rule of non-deductibility include certain gifts made to a veterans' organization or to a domestic fraternal society. In addition, contributions to certain nonprofit cemetery companies are deductible for Federal income tax purposes, but generally are not deductible for Federal estate and gift tax purposes. Secs. 170(c)(3), 170(c)(4), 170(c)(5), 2055(a)(3), 2055(a)(4), 2106(a)(2)(A)(iii), 2522(a)(3), and 2522(a)(4).

resulted in gain that would have been long-term capital gain. Contributions of capital gain property are subject to different percentage limitations (i.e., limitations based on the donor's income) than other contributions of property.

For certain contributions of property, the deductible amount is reduced from the fair market value of the contributed property by the amount of any gain, generally resulting in a deduction equal to the taxpayer's basis. This rule applies to contributions of: (1) ordinary income property, e.g., property that, at the time of contribution, would not have resulted in long-term capital gain if the property was sold by the taxpayer on the contribution date;[175] (2) tangible personal property that is used by the donee in a manner unrelated to the donee's exempt (or governmental) purpose; and (3) property to or for the use of a private foundation (other than a foundation defined in section 170(b)(1)(E)).

Charitable contributions of taxidermy are subject to the tangible personal property rule (number (2) above). For example, for appreciated taxidermy, if the property is used to further the donee's exempt purpose, the deduction is fair market value. But if the property is not used to further the donee's exempt purpose, the deduction is the donor's basis. If the taxidermy is depreciated, i.e., the value is less than the taxpayer's basis in such property, taxpayers generally deduct the fair market value of such contributions, regardless of whether the property is used for exempt or unrelated purposes by the donee.

<u>Substantiation</u>

No charitable deduction is allowed for any contribution of $250 or more unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgement of the contribution by the donee organization.[176] Such acknowledgement must include the amount of cash and a description (but not value) of any property other than cash contributed, whether the donee provided any goods or services in consideration for the contribution (and a good faith estimate of the value of any such goods or services).

In general, if the total charitable deduction claimed for non-cash property is more than $500, the taxpayer must attach a completed Form 8283 (Noncash Charitable Contributions) to the taxpayer's return or the deduction is not allowed.[177] C corporations (other than personal service corporations and closely-held corporations) are required to file Form 8283 only if the deduction claimed is more than $5,000. Information required on the Form 8283 includes, among other things, a description of the property, the appraised fair market value (if an appraisal is required), the donor's basis in the property, how the donor acquired the property, a declaration by the appraiser regarding the appraiser's general qualifications, an acknowledgement by the

[175] 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 appreciation (i.e., basis plus one half of fair market value in excess of basis) or (2) two times basis. Sec. 170(e)(3), 170(e)(4), 170(e)(6).

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

[177] Sec. 170(f)(11).

donee that it is eligible to receive deductible contributions, and an indication by the donee whether the property is intended for an unrelated use.

Taxpayers are required to obtain a qualified appraisal for donated property with a value of more than $5,000 or more, and to attach an appraisal summary to the tax return.[178] Under Treasury regulations, a qualified appraisal means an appraisal document that, among other things: (1) relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property and not later than the due date (including extensions) of the return on which a deduction is first claimed under section 170;[179] (2) is prepared, signed, and dated by a qualified appraiser; (3) includes (a) a description of the property appraised; (b) the fair market value of such property on the date of contribution and the specific basis for the valuation; (c) a statement that such appraisal was prepared for income tax purposes; (d) the qualifications of the qualified appraiser; and (e) the signature and taxpayer identification number of such appraiser; and (4) does not involve an appraisal fee that violates certain prescribed rules.[180] In the case of contributions of art valued at more than $20,000 and other contributions of more than $500,000, taxpayers are required to attach the appraisal to the tax return. Taxpayers may request a Statement of Value from the Internal Revenue Service in order to substantiate the value of art with an appraised value of $50,000 or more for income, estate, or gift tax purposes.[181] The fee for such a Statement is $2,500 for one, two, or three items or art plus $250 for each additional item.

If a donee organization sells, exchanges, or otherwise disposes of contributed property with a claimed value of $5,000 or more (other than publicly traded securities) within two years of the property's receipt, the donee is required to file a return (Form 8282) with the Secretary, and to furnish a copy of the return to the donor, showing the name, address, and taxpayer identification number of the donor, a description of the property, the date of the contribution, the amount received on the disposition, and the date of the disposition.[182]

Description of Proposal

Donation of taxidermy for an exempt use

For contributions of exempt-use taxidermy property with a claimed value of more than $500 but not more than $5,000, the individual must include on the Form 8283 a photograph of the taxidermy and comparable sales data for similar items within the previous six months. Valuation must be based on comparable sales. The Secretary shall not allow a deduction if sufficient comparable sales are not provided.

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[178] *Id*.

[179] In the case of a deduction first claimed or reported on an amended return, the deadline is the date on which the amended return is filed.

[180] Treas. Reg. sec. 1.170A-13(c)(3). Sec. 170(f)(11)(E).

[181] Rev. Proc. 96-15, 1996-1 C.B. 627.

[182] Sec. 6050L(a)(1).

For claims of more than $5,000, the taxpayer must request a Statement of Value from the IRS by the time the taxpayer files the return claiming the deduction. The Statement of Value is similar to that available under present law for items of art. The IRS shall assess an average fee of $500 for the Statement of Value.

Determination of basis in taxidermy

For purposes of the charitable contribution deduction, a taxpayer may not include in the taxpayer's basis of the contributed taxidermy any costs attributable to travel.

Recapture of tax benefit upon subsequent disposition of tangible personal property intended for an exempt use

In general, the proposal recovers the tax benefit for charitable contributions of tangible personal property that are not used for exempt purposes. The proposal applies to appreciated tangible personal property that is identified by the donee organization as for a use related to the donee's basis for tax exemption, and for which a deduction of more than $5,000 is claimed ("applicable property").[183] If the donee organization disposes of applicable property within three years of the receipt of the property, the donor is subject to recapture of the tax benefit. If the disposition occurs in the contribution tax year, the donor's deduction generally is basis and not fair market value.[184] If the disposition occurs in a subsequent year, the donor must include as ordinary income for its taxable year in which the disposition occurs an amount equal to the excess (if any) of (i) the amount of the deduction previously claimed by the donor as a charitable contribution with respect to such property, over (ii) the donor's basis in such property at the time of the contribution.

There is no recapture of the tax benefit if the donee organization makes a certification to the Secretary, by written statement signed under penalties of perjury by an officer of the organization (other than the donor or a person related to the donor). The certification must explain either (1) the use of the property and how such use substantially furthered the purpose or function that constitutes the organization's basis for exemption, or (2) that the intended related use of the property became impossible or infeasible to implement. The organization must furnish a copy of the certification to the donor (as part of the present-law requirement to furnish the Form 8282 to the donor).

Reporting of exempt use property contributions

In addition to the present-law requirement that the donee organization identify on the Form 8283 whether property for which an amount of more than $500 is claimed is for a related use, the donee must explain any such intended use of such property. A penalty of $10,000

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[183] Present law rules continue to apply to any contribution of exempt use property for which a deduction of $5,000 or less is claimed.

[184] The disposition proceeds are regarded as relevant to a determination of fair market value.

applies to a person that identifies property as related use property knowing that it is not intended for such use.[185]

The proposal modifies the present-law information return requirements that apply upon the disposition of contributed property by a charitable organization (Form 8282, sec. 6050L). For property identified by the donee organization on the Form 8283 as exempt use property, the return requirement is extended to dispositions made within three years after receipt (from two years). The donee organization also must provide, in addition to the information already required to be provided on the return, a description of the donee's use of the property, a statement of whether the property was used to substantially further exempt purposes, a certification of any such use (described above).

Effective Date

With respect to contributions of taxidermy property, the proposal is effective for contributions made after the date of enactment. With respect to exempt use property generally, the proposal is effective for contributions made after June 1, 2006.

15. Limit charitable deduction for contributions of clothing and household items and modify recordkeeping and substantiation requirements for certain charitable contributions

Present Law

Deductibility of charitable contributions

In general

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 501(c)(3) or to a Federal, State, or local governmental entity.[186] The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced or limited depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.[187] In general, more generous charitable contribution deduction rules apply to gifts made to public charities than to gifts made to private foundations. Within certain limitations, donors also are entitled to deduct their contributions to section 501(c)(3) organizations for Federal estate and gift tax purposes. By contrast, contributions to nongovernmental, non-charitable tax-exempt

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[185] Other present-law penalties also may apply, such as the penalty for aiding and abetting the understatement of tax liability under section 6701.

[186] The deduction also is allowed for purposes of calculating alternative minimum taxable income.

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

organizations generally are not deductible by the donor,[188] though such organizations are eligible for the exemption from Federal income tax with respect to such donations.

Contributions of property

The amount of the deduction for charitable contributions of capital gain property generally equals the fair market value of the contributed property on the date of the contribution. Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property are subject to different percentage limitations than other contributions of property.

For certain contributions of property, the deductible amount is reduced from the fair market value of the contributed property by the amount of any gain, generally resulting in a deduction equal to the taxpayer's basis. This rule applies to contributions of: (1) ordinary income property, e.g., property that, at the time of contribution, would not have resulted in long-term capital gain if the property was sold by the taxpayer on the contribution date;[189] (2) tangible personal property that is used by the donee in a manner unrelated to the donee's exempt (or governmental) purpose; and (3) property to or for the use of a private foundation (other than a foundation defined in section 170(b)(1)(E)).

Charitable contributions of clothing and household items are subject to the tangible personal property rule (number (2) above). If such contributed property is appreciated property in the hands of the taxpayer, and is not used to further the donee's exempt purpose, the deduction is basis. In general, however, the value of clothing and household items is less than the taxpayer's basis in such property, with the result that taxpayers generally deduct the fair market value of such contributions, regardless of whether the property is used for exempt or unrelated purposes by the donee.

Substantiation

A donor who claims a deduction for a charitable contribution must maintain reliable written records regarding the contribution, regardless of the value or amount of such contribution. For a contribution of money, the donor generally must maintain one of the following: (1) a cancelled check; (2) a receipt (or a letter or other written communication) from the donee showing the name of the donee organization, the date of the contribution, and the

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[188] Exceptions to the general rule of non-deductibility include certain gifts made to a veterans' organization or to a domestic fraternal society. In addition, contributions to certain nonprofit cemetery companies are deductible for Federal income tax purposes, but generally are not deductible for Federal estate and gift tax purposes. Secs. 170(c)(3), 170(c)(4), 170(c)(5), 2055(a)(3), 2055(a)(4), 2106(a)(2)(A)(iii), 2522(a)(3), and 2522(a)(4).

[189] For certain contributions of inventory and other property, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one half of fair market value in excess of basis) or (2) two times basis. Sec. 170(e)(3), 170(e)(4), 170(e)(6).

amount of the contribution; or (3) in the absence of a cancelled check or a receipt, other reliable written records showing the name of the donee, the date of the contribution, and the amount of the contribution. For a contribution of property other than money, the donor generally must maintain a receipt from the donee organization showing the name of the donee, the date and location of the contribution, and a detailed description (but not the value) of the property.[190] A donor of property other than money need not obtain a receipt, however, if circumstances make obtaining a receipt impracticable. Under such circumstances, the donor must maintain reliable written records regarding the contribution. The required content of such a record varies depending upon factors such as the type and value of property contributed.[191]

In addition to the foregoing recordkeeping requirements, substantiation requirements apply in the case of charitable contributions with a value of $250 or more. No charitable deduction is allowed for any contribution of $250 or more unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgement of the contribution by the donee organization. Such acknowledgement must include the amount of cash and a description (but not value) of any property other than cash contributed, whether the donee provided any goods or services in consideration for the contribution, and a good faith estimate of the value of any such goods or services.[192] In general, if the total charitable deduction claimed for non-cash property is more than $500, the taxpayer must attach a completed Form 8283 (Noncash Charitable Contributions) to the taxpayer's return or the deduction is not allowed.[193] In general, taxpayers are required to obtain a qualified appraisal for donated property with a value of more than $5,000, and to attach an appraisal summary to the tax return.

Description of Proposal

General rule relating to clothing and household items

The proposal requires the Secretary to prepare and publish an itemized list of clothing and household items and to assign an amount to each item on the list. The assigned amount is treated as the fair market value of the item for purposes of the charitable contribution deduction and is based on an assumption that the item is in good used condition or better. Any deduction for a charitable contribution of each such item may not exceed the item's assigned amount. Any deduction for an item not in good used condition or better may not exceed 20 percent of the item's assigned amount. Any deduction for an item that is not functional with respect to the use for which it was designed is not allowed.

The list must be published by the Secretary at least once each calendar year and is applicable to contributions of clothing and household items made while the list is effective. The

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[190] Treas. Reg. sec. 1.170A-13(a).

[191] Treas. Reg. sec. 1.170A-13(b).

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

[193] Sec. 170(f)(11).

Secretary has discretion to determine the effective dates for each published list. The list should be prepared in consultation with donee organizations that accept charitable contributions of clothing and household items. In assigning amounts to particular items, the Secretary should take into account the sales price of such contributed items when sold by the donee organizations, whether through an exempt program of such organizations or otherwise. If an item of clothing or a household item is not included on the list published by the Secretary, present law rules apply to the contribution of the item.

The proposal does not apply to contributions by C corporations. The proposal applies to new and used items. Household items include furniture, furnishings, electronics, appliances, linens, and other similar items. Food is not considered a household item. Paintings, antiques, and other objects of art, jewelry and gems, and collections are excluded from the proposal.

Substantiation

Clothing and household items

As under present law, for contributions with a claimed value of $250 or more, the taxpayer must obtain contemporaneous substantiation from the donee organization, which must include a description of the property contributed. The proposal provides that, as part of such substantiation, the taxpayer obtain an indication of the condition of the item(s) and the number and type of items of clothing and household items contributed and either a copy of the published list or instructions as to how to find such list.

Under present law, if a taxpayer claims that the total value of charitable contributions of noncash property is more than $500, the taxpayer must include with the taxpayer's return a description of the property contributed and such other information as the Secretary may require in order to claim a charitable deduction (sec. 170(f)(11)(B)). This requirement presently is satisfied through completion by the taxpayer of the Form 8283 and attachment of the form to the taxpayer's return. The proposal requires that the donor include the information about the contribution that is contained in the contemporaneous substantiation obtained from the donee organization (for gifts of $250 or more) as part of such requirement.

Contributions of $100 or more

Under the proposal, the substantiation requirements that currently apply with respect to charitable contributions of $250 or more (sec. 170(f)(8)) apply to all charitable contributions with a value of $100 or more.

Contributions of cash

In addition, in the case of a charitable contribution of money, regardless of the amount, applicable recordkeeping requirements are satisfied under the proposal only if the donor maintains a cancelled check or a receipt (or a letter or other written communication) from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution. The recordkeeping requirements may not be satisfied by maintaining other written records.

Effective Date

The proposal relating to clothing and household items is effective for contributions made after January 1, 2007. The proposal relating to substantiation more generally is effective for contributions made in taxable years beginning after the date of enactment.

16. Contributions of fractional interests in tangible personal property

Present Law

In general, a charitable deduction is not allowable for a contribution of a partial interest in property, such as an income interest, a remainder interest, or a right to use property.[194] A gift of an undivided portion of a donor's entire interest in property generally is not treated as a nondeductible gift of a partial interest in property.[195] For this purpose, an undivided portion of a donor's entire interest in property must consist of a fraction or percentage of each and every substantial interest or right owned by the donor in such property and must extend over the entire term of the donor's interest in such property.[196] A gift generally is treated as a gift of an undivided portion of a donor's entire interest in property if the donee is given the right, as a tenant in common with the donor, to possession, dominion, and control of the property for a portion of each year appropriate to its interest in such property.[197]

Consistent with these requirements, a charitable contribution deduction generally is not allowable for a contribution of a future interest in tangible personal property.[198] For this purpose, a future interest is one "in which a donor purports to give tangible personal property to a charitable organization, but has an understanding, arrangement, agreement, etc., whether written or oral, with the charitable organization which has the effect of reserving to, or retaining in, such donor a right to the use, possession, or enjoyment of the property."[199] Treasury regulations provide that section 170(a)(3), which generally denies a deduction for a contribution of a future interest in tangible personal property, "[has] no application in respect of a transfer of an undivided present interest in property. For example, a contribution of an undivided one-quarter interest in a painting with respect to which the donee is entitled to possession during three months of each year shall be treated as made upon the receipt by the donee of a formally

[194] Secs. 170(f)(3)(A) (income tax), 2055(e)(2) (estate tax), and 2522(c)(2) (gift tax).

[195] Sec. 170(f)(3)(B)(ii).

[196] Treas. Reg. sec. 1.170A-7(b)(1).

[197] Treas. Reg. sec. 1.170A-7(b)(1).

[198] Sec. 170(a)(3).

[199] Treas. Reg. sec. 1.170A-5(a)(4).

executed and acknowledged deed of gift. However, the period of initial possession by the donee may not be deferred in time for more than one year."[200]

Description of Proposal

Require consistent valuation of fractional interests in the same item of property

In general, under present law and the proposal a donor may take a deduction for a charitable contribution of a fractional interest in tangible personal property (such as an artwork), provided the donor satisfies the requirements for deductibility (including the requirements concerning contributions of partial interests and future interests in property), and in subsequent years make additional charitable contributions of interests in the same property.[201] Under the proposal, a donor's charitable deduction for the initial contribution of a fractional interest in an item of tangible personal property (or collection of such items) shall be determined as under current law (e.g., based upon the fair market value of the artwork at the time of the contribution of the fractional interest and considering whether the use of the artwork will be related to the donee's exempt purposes). For purposes of determining the deductible amount of each additional contribution of an interest (whether or not a fractional interest) in the same item of property, under the proposal, the fair market value of the item shall be the lesser of: (1) the value used for purposes of determining the charitable deduction for the initial fractional contribution; or (2) the fair market value of the item at the time of the subsequent contribution. This portion of the proposal applies for income, gift, and estate tax purposes.

Require actual possession by the donee

The proposal provides for recapture of the income tax charitable deduction or gift tax charitable deduction under certain circumstances. Specifically, if, during any one-year period following a contribution of a fractional interest in an item of tangible personal property, the donee fails to take actual possession of the item for a period of time corresponding substantially to the donee's then-existing percentage interest in the item, then the donee's charitable deduction for all previous contributions of interests in the item shall be recaptured (plus interest).

Under the proposal, the Secretary of the Treasury is authorized to promulgate rules to prevent the circumvention of the proposal by, for example, engaging in a transaction in which a donor first transfers one or more items of tangible personal property to a separate entity in exchange for ownership interests in the entity, and subsequently makes charitable contributions of such ownership interests.

Effective Date

The proposal is applicable for contributions made after the date of enactment.

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[200] Treas. Reg. sec. 1.170A-5(a)(2).

[201] See, e.g., *Winokur v. Commissioner*, 90 T.C. 733 (1988).

17. Provisions relating to substantial and gross overstatement of valuations of property

Present Law

Taxpayer penalties

Present law imposes accuracy-related penalties on a taxpayer in cases involving a substantial valuation misstatement or gross valuation misstatement relating to an underpayment of income tax.[202] For this purpose, a substantial valuation misstatement generally means a value claimed that is at least twice (200 percent or more) the amount determined to be the correct value, and a gross valuation misstatement generally means a value claimed that is at least four times (400 percent or more) the amount determined to be the correct value.

The penalty is 20 percent of the underpayment of tax resulting from a substantial valuation misstatement and rises to 40 percent for a gross valuation misstatement. No penalty is imposed unless the portion of the underpayment attributable to the valuation misstatement exceeds $5,000 ($10,000 in the case of a corporation other than an S corporation or a personal holding company). Under present law, no penalty is imposed with respect to any portion of the understatement attributable to any item if (1) the treatment of the item on the return is or was supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed on the return or on a statement attached to the return and there is a reasonable basis for the tax treatment. Special rules apply to tax shelters.

In addition, the accuracy-related penalty does not apply if a taxpayer shows there was reasonable cause for an underpayment and the taxpayer acted in good faith.[203]

Penalty for aiding and abetting understatement of tax

A penalty is imposed on a person who: (1) aids or assists in or advises with respect to a tax return or other document; (2) knows (or has reason to believe) that such document will be used in connection with a material tax matter; and (3) knows that this would result in an understatement of tax of another person. In general, the amount of the penalty is $1,000. If the document relates to the tax return of a corporation, the amount of the penalty is $10,000.

Qualified appraisals

Present law requires a taxpayer to obtain a qualified appraisal for donated property with a value of more than $5,000, and to attach an appraisal summary to the tax return.[204] Treasury Regulations state that a qualified appraisal means an appraisal document that, among other things: (1) relates to an appraisal that is made not earlier than 60 days prior to the date of

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[202] Sec. 6662(b)(3) and (h).

[203] Sec. 6664(c).

[204] Sec. 170(f)(11).

contribution of the appraised property and not later than the due date (including extensions) of the return on which a deduction is first claimed under section 170; (2) is prepared, signed, and dated by a qualified appraiser; (3) includes (a) a description of the property appraised; (b) the fair market value of such property on the date of contribution and the specific basis for the valuation; (c) a statement that such appraisal was prepared for income tax purposes; (d) the qualifications of the qualified appraiser; and (e) the signature and taxpayer identification number of such appraiser; and (4) does not involve an appraisal fee that violates certain prescribed rules.[205]

Qualified appraisers

Treasury Regulations define a qualified appraiser a person who holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis, is qualified to make appraisals of the type of property being valued (as determined by the appraiser's background, experience, education and membership, if any, in professional appraisal associations), is independent, and understands that an intentionally false or fraudulent overstatement of the value of the appraised property may subject the appraiser to civil penalties.[206]

Appraiser oversight

The Secretary is authorized to regulate the practice of representatives of persons before the Department of the Treasury ("Department").[207] After notice and hearing, the Secretary is authorized to suspend or disbar from practice before the Department or the Internal Revenue Service ("IRS") a representative who is incompetent, who is disreputable, who violates the rules regulating practice before the Department or the IRS, or who (with intent to defraud) willfully and knowingly misleads or threatens the person being represented (or a person who may be represented).

The Secretary also is authorized to bar from appearing before the Department or the IRS, for the purpose of offering opinion evidence on the value of property or other assets, any individual against whom a civil penalty for aiding and abetting the understatement of tax has been assessed. Thus, an appraiser who aids or assists in the preparation or presentation of an appraisal will be subject to disciplinary action if the appraiser knows that the appraisal will be used in connection with the tax laws and will result in an understatement of the tax liability of another person. The Secretary has authority to provide that the appraisals of an appraiser who has been disciplined have no probative effect in any administrative proceeding before the Department or the IRS.

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[205] Treas. Reg. sec. 1.170A-13(c)(3).

[206] Treas. Reg. sec. 1.170A-13(c)(5)(i).

[207] 31 U.S.C. sec. 330.

Description of Proposal

Taxpayer penalties

The proposal lowers the thresholds for imposing accuracy-related penalties on a taxpayer who claims a deduction for donated property for which a qualified appraisal is required. Under the proposal, a substantial valuation misstatement exists when the claimed value of donated property is 150 percent or more of the amount determined to be the correct value. A gross valuation misstatement occurs when the claimed value of donated property is 200 percent or more the amount determined to be the correct value. Under the proposal, the reasonable cause exception to the accuracy-related penalty does not apply in the case of gross valuation misstatements.

Appraiser oversight

Appraiser penalties

The proposal establishes a civil penalty on any person who prepares an appraisal that is to be used to support a tax position if such appraisal results in a substantial or gross valuation misstatement. The penalty is equal to the greater of $1,000 or 10 percent of the understatement of tax resulting from a substantial or gross valuation misstatement, up to a maximum of 125 percent of the gross income derived from the appraisal. Under the proposal, the penalty does not apply if the appraiser establishes that it was "more likely than not" that the appraisal was correct.

Disciplinary proceeding

The proposal eliminates the requirement that the Secretary assess against an appraiser the civil penalty for aiding and abetting the understatement of tax before such appraiser may be subject to disciplinary action. Thus, the Secretary is authorized to discipline appraisers after notice and hearing. Disciplinary action may include, but is not limited to, suspending or barring an appraiser from: preparing or presenting appraisals on the value of property or other assets to the Department or the IRS; appearing before the Department or the IRS for the purpose of offering opinion evidence on the value of property or other assets; and providing that the appraisals of an appraiser who have been disciplined have no probative effect in any administrative proceeding before the Department or the IRS.

Qualified appraisers

The proposal defines a qualified appraiser as an individual who (1) has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements to be determined by the IRS in regulations; (2) regularly performs appraisals for which he or she receives compensation; (3) can demonstrate verifiable education and experience in valuing the type of property for which the appraisal is being performed; (4) has not been prohibited from practicing before the IRS by the Secretary at any time during the three years preceding the conduct of the appraisal; and (5) is not excluded from being a qualified appraiser under applicable Treasury regulations.

Qualified appraisals

The proposal defines a qualified appraisal as an appraisal of property prepared by a qualified appraiser (as defined by the proposal) in accordance with generally accepted appraisal standards and any regulations or other guidance prescribed by the Secretary.

Effective Date

The proposal amending the accuracy-related penalty applies to returns filed after the date of enactment. The proposal establishing a civil penalty on any person who prepares an appraisal that is to be used to support a tax position if such appraisal results in a substantial or gross valuation misstatement applies to appraisals prepared with respect to returns filed after the date of enactment. The proposals relating to appraiser oversight apply to returns filed after the date of enactment.

18. Expand the base of the tax on private foundation net investment income

Present Law

In general

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,[208] also are subject to an excise tax under section 4940(b) based on net investment income and unrelated business income. The two-percent rate of tax is reduced to one-percent if certain requirements are met in a taxable year.[209] Unlike certain other excise taxes imposed on private foundations, the tax based on investment income does not result from a violation of substantive law by the private foundation; it is solely an excise tax.

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.

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[208] *See* sec. 4947(a)(1).

[209] Sec. 4940(e).

Net investment income

Internal Revenue Code

In general, 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.[210]

Gross investment income is the gross amount of income from interest, dividends, rents, payments with respect to securities loans, and royalties. Gross investment income does not include any income that is included in computing a foundation's unrelated business taxable income.[211]

Capital gain net income takes into account only gains and losses from the sale or other disposition of property used for the production of interest, dividends, rents, and royalties, and property used for the production of income included in computing the unrelated business income tax (except to the extent the gain or loss is taken into account for purposes of such tax). Losses from sales or other dispositions of property are allowed only to the extent of gains from such sales or other dispositions, and no capital loss carryovers are allowed.[212]

Treasury Regulations and case law

The Treasury regulations elaborate on the Code definition of net investment income. The regulations cite items of investment income listed in the Code, and in addition clarify that net investment income includes interest, dividends, rents, and royalties derived from all sources, including from assets devoted to charitable activities. For example, interest received on a student loan is includible in the gross investment income of a foundation making the loan.[213]

The regulations further provide that gross investment income includes certain items of investment income that are described in the unrelated business income tax regulations.[214] Such additional items include payments with respect to securities loans (an item added to the Code in 1978), annuities, income from notional principal contracts, and other substantially similar income from ordinary and routine investments to the extent determined by the Commissioner.[215] These latter three categories of income are not enumerated as net investment income in the Code.

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[210] Sec. 4940(c)(1). 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). Sec. 4940(c)(5).

[211] Sec. 4940(c)(2).

[212] Sec. 4940(c)(4).

[213] Treas. Reg. sec. 53.4940-1(d)(1).

[214] *Id*.

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

The Treasury regulations also elaborate on the Code definition of capital gain net income. The regulations provide that the only capital gains and losses that are taken into account are (1) gains and losses from the sale or other disposition of property held by a private foundation for investment purposes (other than program related investments), and (2) property used for the production of income included in computing the unrelated business income tax (except to the extent the gain or loss is taken into account for purposes of such tax).

This definition of capital gain net income builds on the definition provided in the Code by providing an exception for gain and loss from program related investments and by stating, in addition, that "gains and losses from the sale or other disposition of property used for the exempt purposes of the private foundation are excluded."[216] As an example, the regulations provide that gain or loss on the sale of buildings used for the foundation's exempt activities are not taken into account for purposes of the section 4940 tax. If a foundation uses exempt income for exempt purposes and (other than incidentally) for investment purposes, then the portion of the gain or loss received upon sale or other disposition that is allocable to the investment use is taken into account for purposes of the tax.

The regulations further provide that "property shall be treated as held for investment purposes even though such property is disposed of by the foundation immediately upon its receipt, if it is property of a type which generally produces interest, dividends, rents, royalties, or capital gains through appreciation (for example, rental real estate, stock, bonds, mineral interest, mortgages, and securities)."[217]

This regulation has been challenged in the courts. The regulation says that property is treated as held for investment purposes if it is of a type that "generally produces" certain types of income. By contrast, the Code provides that the property be "used" to produce such income. In *Zemurray Foundation v. United States*, 687 F.2d 97 (5th Cir. 1982), the taxpayer foundation challenged the Treasury's attempt to tax under section 4940 capital gain on the sale of timber property. The taxpayer asserted that the property was not actually used to produce investment income, and that the Treasury Regulation was invalid because the regulation would subject to tax property that is of a type that could generally be used to produce investment income. On this issue, the court upheld the Treasury regulation, reasoning that the regulation's use of the phrase "generally used," though permitting taxation "so long as the property sold is *usable* to produce the applicable types of income, regardless of whether the property is actually used to produce income or not" was not unreasonable or plainly inconsistent with the statute.[218] However, on remand to the district court, the district court concluded that the timber property at issue, though a type of property generally used to produce investment income, was not susceptible for such use.[219] Thus, the district court concluded that the Treasury could not tax the gain under this portion of the regulation.

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[216] Treas. Reg. sec. 53.4940-1(f)(1).

[217] *Id.*

[218] *Zemurray Foundation v. United States*, 687 F.2d 97, 100 (5th Cir. 1982).

[219] *Zemurray Foundation v. United States*, 53 A.F.T.R. 2d (RIA) 842 (E. D. La. 1983).

The question then turned to the taxpayer's second challenge to the regulation. At issue was the meaning of the regulatory phrase "capital gains through appreciation." The regulation provides that if property is of a type that generally produces capital gains through appreciation, then the gain is subject to tax. The Treasury argued that the timber property at issue, although held by the court not to be property (in this case) susceptible for use to produce interest, dividends, rents, or royalties, still was held by the taxpayer to produce capital gain through appreciation and therefore the gain should be subject to tax under the regulation.

On this issue, the court held for the taxpayer, reasoning that the language of the Code clearly is limited to certain gains and losses, e.g., the court cited the Code language providing that "there shall be taken into account *only* gains and losses from the sale or other disposition of property used for the production of interest, dividends, rents, and royalties . . . ."[220] The court noted that "capital gains through appreciation" is not enumerated in the statute. The court used as an example a jade figurine held by a foundation. Jade figurines do not generally produce interest, dividends, rents, or royalties, but gain on the sale of such a figurine would be taxable under the "capital gains through appreciation" standard, yet such standard does not appear in the statute. After *Zemurray*, the Treasury generally conceded this issue.[221]

With respect to capital losses, the Code provides that carryovers are not permitted, whereas the regulations state that neither carryovers nor carrybacks are permitted.[222]

Application of *Zemurray* to the Code and the regulations

Applying the *Zemurray* case to the Code and regulations results in a general principle for purposes of present law: private foundations are subject to tax under section 4940 only on the items of income and only on gains and losses specifically enumerated therein. Under this principle, private foundations generally are not subject to the section 4940 tax on other substantially similar types of income from ordinary and routine investments, notwithstanding Treasury regulations to the contrary. In addition, the regulations provide that gain or loss from the sale or other disposition of assets used for exempt purposes, with specific reference to program-related investments, is excluded. The Code provides for no such blanket exclusion; thus, under the language of the Code and the reasoning of *Zemurray*, if a foundation provided office space at below market rent to a charitable organization for use in the organization's exempt purposes, gain on the sale of the building by the foundation should be subject to the section 4940 tax despite the Treasury regulations.[223]

[220] *Zemurray Foundation v. United States*, 755 F.2d 404 (5th Cir. 1985), 413 (citing Code sec. 4940(c)(4)(A).

[221] G.C.M. 39538 (July 23, 1986).

[222] Treas. Reg. sec. 53.4940-1(f)(3).

[223] *See also* the example in Treas. Reg. sec. 53.4940-1(f)(1).

In addition, under the logic of *Zemurray*, capital loss carrybacks arguably are permitted, notwithstanding Treasury regulations to the contrary, because the Code mentions only a bar on use of carryovers and says nothing about carrybacks.

Description of Proposal

The proposal amends the definition of gross investment income to include certain items of income not presently enumerated in the Code but identified in Treasury regulations, namely, income from notional principal contracts, annuities, and other substantially similar income from ordinary and routine investments. In addition, the capital gains and losses subject to the tax are modified to include capital gains from appreciation, including capital gains and losses from the sale or other disposition of assets used to further an exempt purpose.

The proposal provides that there are no carrybacks of losses from sales or other dispositions of property.

Effective Date

The proposal is effective for taxable years beginning after the date of enactment.

19. Establish additional exemption standards for credit counseling organizations

Present Law

Under present law, a credit counseling organization may be exempt as a charitable or educational organization described in section 501(c)(3), or as a social welfare organization described in section 501(c)(4). The IRS has issued two revenue rulings holding that certain credit counseling organizations are exempt as charitable or educational organizations or as social welfare organizations.

In Revenue Ruling 65-299,[224] an organization whose purpose was to assist families and individuals with financial problems, and help reduce the incidence of personal bankruptcy, was determined to be a social welfare organization described in section 501(c)(4). The organization counseled people in financial difficulties, advised applicants on payment of debts, and negotiated with creditors and set up debt repayment plans. The organization did not restrict its services to the poor, made no charge for counseling services, and made a nominal charge for certain services to cover postage and supplies. For financial support, the organization relied on voluntary contributions from local businesses, lending agencies, and labor unions.

In Revenue Ruling 69-441,[225] the IRS ruled an organization was a charitable or educational organization exempt under section 501(c)(3) by virtue of aiding low-income people who had financial problems and providing education to the public. The organization in that

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[224] Rev. Rul. 65-299, 1965-2 C.B. 165.

[225] Rev. Rul. 69-441, 1969-2 C.B. 115.

ruling had two functions: (1) educating the public on personal money management, such as budgeting, buying practices, and the sound use of consumer credit through the use of films, speakers, and publications; and (2) providing individual counseling to low-income individuals and families without charge. As part of its counseling activities, the organization established debt management plans for clients who required such services, at no charge to the clients.[226] The organization was supported by contributions primarily from creditors, and its board of directors was comprised of representatives from religious organizations, civic groups, labor unions, business groups, and educational institutions.

In 1976, the IRS denied exempt status to an organization, Consumer Credit Counseling Service of Alabama, whose activities were distinguishable from those in Revenue Ruling 69-441 in that (1) it did not restrict its services to the poor, and (2) it charged a nominal fee for its debt management plans.[227] The organization provided free information to the general public through the use of speakers, films, and publications on the subjects of budgeting, buying practices, and the use of consumer credit. It also provided counseling to debt-distressed individuals, not necessarily poor or low-income, and provided debt management plans at the cost of $10 per month, which was waived in cases of financial hardship. Its debt management activities were a relatively small part of its overall activities. The district court determined the organization qualified as charitable and educational within section 501(c)(3), finding the debt management plans to be an integral part of the agency's counseling function, and that its debt management activities were incidental to its principal functions, as only approximately 12 percent of the counselors' time was applied to such programs and the charge for the service was nominal. The court also considered the facts that the agency was publicly supported, and that it had a board dominated by members of the general public, as factors indicating a charitable operation.[228]

A recent estimate shows the number of credit counseling organizations increased from approximately 200 in 1990 to over 1,000 in 2002.[229] During the period from 1994 to late 2003, 1,215 credit counseling organizations applied to the IRS for tax exempt status under section 501(c)(3), including 810 during 2000 to 2003.[230] The IRS has recognized more than 850 credit

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[226] Debt management plans are debt payment arrangements, including debt consolidation arrangements, entered into by a debtor and one or more of the debtor's creditors, generally structured to reduce the amount of a debtor's regular ongoing payment by modifying the interest rate, minimum payment, maturity or other terms of the debt. Such plans frequently are promoted as a means for a debtor to restructure debt without filing for bankruptcy.

[227] *Consumer Credit Counseling Service of Alabama, Inc. v. U.S.*, 44 A.F.T.R. 2d (RIA) 5122 (D.D.C. 1978). The case involved 24 agencies throughout the United States.

[228] *See also*, *Credit Counseling Centers of Oklahoma, Inc., v. U.S.*, 45 A.F.T.R. 2d (RIA) 1401 (D.D.C. 1979) (holding the same on virtually identical facts).

[229] Opening Statement of The Honorable Max Sandlin, Hearing on Non-Profit Credit Counseling Organizations, House Ways and Means Committee, Subcommittee on Oversight (November 20, 2003).

[230] United States Senate Permanent Subcommittee on Investigations, Committee on Governmental Affairs, *Profiteering in a Non-Profit Industry: Abusive Practices in Credit Counseling*,

counseling organizations as tax exempt under section 501c)((3).[231] Few credit counseling organizations have sought section 501(c)(4) status, and the IRS reports it has not seen any significant increase in the number or activity of such organizations operating as social welfare organizations.[232] As of late 2003, there were 872 active tax-exempt credit counseling agencies operating in the United States.[233]

A credit counseling organization described in section 501(c)(3) is exempt from certain Federal and State consumer protection laws that provide exemptions for organizations described therein.[234] Some believe that these exclusions from Federal and State regulation may be a primary motivation for the recent increase in the number of organizations seeking and obtaining exempt status under section 501(c)(3).[235] Such regulatory exemptions generally are not available for social welfare organizations described in section 501(c)(4).

Congress recently conducted hearings investigating the activities of credit counseling organizations under various consumer protection laws,[236] such as the Federal Trade Commission

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Report Prepared by the Majority & Minority Staffs of the Permanent Subcommittee on Investigations and Released in Conjunction with the Permanent Subcommittee Investigations' Hearing on March 24, 2004, p. 3 (citing letter dated December 18, 2003, to the Subcommittee from IRS Commissioner Everson).

[231] Testimony of Commissioner Mark Everson before the House Ways and Means Committee, Subcommittee on Oversight (November 20, 2003).

[232] Testimony of Commissioner Mark Everson before the House Ways and Means Committee, Subcommittee on Oversight (November 20, 2003).

[233] United States Senate Permanent Subcommittee on Investigations, Committee on Governmental Affairs, *Profiteering in a Non-Profit Industry: Abusive Practices in Credit Counseling*, Report Prepared by the Majority & Minority Staffs of the Permanent Subcommittee on Investigations and Released in Conjunction with the Permanent Subcommittee Investigations' Hearing on March 24, 2004, p. 3 (citing letter dated December 18, 2003 to the Subcommittee from IRS Commissioner Everson).

[234] *E.g.*, The Credit Repair Organizations Act, 15 U.S.C. section 1679 *et seq*., effective April 1, 1997 (imposing restrictions on credit repair organizations that are enforced by the Federal Trade Commission, including forbidding the making of untrue or misleading statements and forbidding advance payments; section 501(c)(3) organizations are explicitly exempt from such regulation). Testimony of Commissioner Mark Everson before the House Ways and Means Committee, Subcommittee on Oversight (November 20, 2003) (California's consumer protections laws that impose strict standards on credit service organizations and the credit repair industry do not apply to nonprofit organizations that have received a final determination from the IRS that they are exempt from tax under section 501(c)(3) and are not private foundations).

[235] Testimony of Commissioner Mark Everson before the House Ways and Means Committee, Subcommittee on Oversight (November 20, 2003).

[236] United States Senate Permanent Subcommittee on Investigations, Committee on Governmental Affairs, *Profiteering in a Non-Profit Industry: Abusive Practices in Credit Counseling*, Report Prepared by the Majority & Minority Staffs of the Permanent Subcommittee on Investigations and Released in Conjunction with the Permanent Subcommittee Investigations' Hearing on March 24, 2004.

Act.[237] In addition, the IRS has commenced a broad examination and compliance program with respect to the credit counseling industry, pursuant to which the IRS has initiated audits of 50 credit counseling organizations, including nine of the 15 largest in terms of gross receipts.[238]

Under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, an individual generally may not be a debtor in bankruptcy unless such individual has, within 180 days of filing a petition for bankruptcy, received from an approved nonprofit budget and credit counseling agency an individual or group briefing that outlines the opportunities for available credit counseling and assists the individual in performing a related budget analysis.[239] The clerk of the court must maintain a publicly available list of nonprofit budget and credit counseling agencies approved by the U.S. Trustee (or bankruptcy administrator). In general, the U.S. Trustee (or bankruptcy administrator) shall only approve an agency that demonstrates that it will provide qualified counselors, maintain adequate provision for safekeeping and payment of client funds, provide adequate counseling with respect to client credit problems, and deal responsibly and effectively with other matters relating to the quality, effectiveness, and financial security of the services it provides. The minimum qualifications for approval of such an agency include: (1) in general, having an independent board of directors; (2) charging no more than a reasonable fee, and providing services without regard to ability to pay; (3) adequate provision for safekeeping and payment of client funds; (4) provision of full disclosures to clients; (5) provision of adequate counseling with respect to a client's credit problems; (6) trained counselors who receive no commissions or bonuses based on the outcome of the counseling services; (7) experience and background in providing credit counseling; and (8) adequate financial resources to provide continuing support services for budgeting plans over the life of any repayment plan. An individual debtor must file with the court a certificate from the approved nonprofit budget

[237] 15 U.S.C. sec. 45(a) (prohibiting unfair and deceptive acts or practices in or affecting commerce; although the Federal Trade Commission generally lacks jurisdiction to enforce consumer protection laws against bona fide nonprofit organizations, it may assert jurisdiction over a nonprofit, including a credit counseling organization, if it demonstrates the organization is organized to carry on business for profit, is a mere instrumentality of a for-profit entity, or operates through a common enterprise with one or more for-profit entities).

[238] United States Senate Permanent Subcommittee on Investigations, Committee on Governmental Affairs, *Profiteering in a Non-Profit Industry: Abusive Practices in Credit Counseling*, Report Prepared by the Majority & Minority Staffs of the Permanent Subcommittee on Investigations and Released in Conjunction with the Permanent Subcommittee Investigations' Hearing on March 24, 2004, p. 31.

[239] This requirement does not apply in certain circumstances, such as: (1) in general, where a debtor resides in a district for which the U.S. Trustee has determined that the approved counseling agencies for such district are not reasonably able to provide adequate services to additional individuals; (2) where exigent circumstances merit a waiver, the individual seeking bankruptcy protection files an appropriate certification with the court, and the certification is acceptable to the court; and (3) in general, where a court determines, after notice and hearing, that the individual is unable to complete the requirement because of incapacity, disability, or active military duty in a military combat zone.

and credit counseling agency that provided the required services describing the services provided, and a copy of the debt management plan, if any, developed through the agency.[240]

Description of Proposal

Requirements for exempt status of credit counseling organizations

Under the proposal, an organization that provides credit counseling services as a substantial purpose of the organization ("credit counseling organization") is eligible for exemption from Federal income tax only as a charitable or educational organization under section 501(c)(3) or as a social welfare organization under section 501(c)(4), and only if (in addition to present-law requirements) the credit counseling organization is organized and operated in accordance with the following:

1. The organization provides credit counseling services tailored to the specific needs and circumstances of the consumer.

2. The organization makes no loans to debtors and does not negotiate the making of loans on behalf of debtors,

3. The organization is generally does not provide or promote any service for the purpose of (a) improving any consumer's credit record, credit history, or credit rating;

4. The organization does not refuse to provide credit counseling services to a consumer due to inability of the consumer to pay, the ineligibility of the consumer for debt management plan enrollment, or the unwillingness of a consumer to enroll in a debt management plan;

5. The organization establishes and implements a fee policy to require that any fees charged to a consumer for its services are reasonable, and prohibits charging any fee based in whole or in part on a percentage of the consumer's debt, the consumer's payments to be made pursuant to a debt management plan, or on projected or actual savings to the consumer resulting from enrolling in a debt management plan;

6. The organization at all times has a board of directors or other governing body (a) that is controlled by persons who represent the broad interests of the public, such as public officials acting in their capacities as such, persons having special knowledge or expertise in credit or financial education, and community leaders; (b) not more than 20 percent of the voting power of which is vested in persons who are employed by the organization or who will benefit financially, directly or indirectly, from the agency's activities (other than through the receipt of reasonable directors' fees or the repayment of consumer debt to creditors other than the credit counseling agency or its affiliates) and (c) not more than 49% of the voting power of which is vested in persons who are employed by the

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[240] The Act also requires that, prior to discharge of indebtedness under chapter 7 or chapter 13, a debtor complete an approved instructional course concerning personal financial management, which course need not be conducted by a nonprofit agency.

organization or who will benefit financially, directly or indirectly, from the agency's activities (other than through the receipt of reasonable directors' fees);

7. The organization receives no amount for providing referrals to others for financial services (including debt management services) to be provided to consumers, and pays no amount to others for obtaining referrals of consumers; and

8. The organization is not related to an organization in the business of credit repair, to a person that is in the business of lending money, or to a person that provides debt management plan services, payment processing, and similar services. Additional requirements for charitable or educational organizations.

Additional requirements for charitable and educational organizations

Under the proposal, a credit counseling organization is described in section 501(c)(3) only if, in addition to satisfying the above requirements, the organization is organized and operated such that the organization (1) charges no fees (other than nominal fees) for debt management plan services and waives any fees if payment of such fees would work a financial hardship; (2) does not solicit contributions from consumers during the initial counseling process or while the consumer is receiving services from the organization; (3) normally limits debt management plan services (in the aggregate) to 25 percent of the organization's total activities (determined by taking into account time, resources, source of revenues or effort expended by the organization, and any other measures prescribed by the Secretary).[241] The 25-percent limit shall be applied with regard only to the activities of the credit counseling organization, and without regard to the activities of any affiliates, separately organized entities, or entities that, together with the credit counseling organization, are covered by a group exemption determination letter. The Secretary is authorized to promulgate rules designed to prevent circumvention of this requirement.

Additional requirements for social welfare organizations

Under the proposal, a credit counseling organization is described in section 501(c)(4) only if, in addition to satisfying the above requirements applicable to such organizations, it is organized and operated such that the organization charges no fees (other than nominal fees) for its credit counseling services, and waives any fees if payment of such fees would work a financial hardship. In addition, a credit counseling organization shall not be treated as an organization described in section 501(c)(4) unless such organization applies for recognition of exempt status under procedures similar to those described in section 508(a) (applicable to section 501(c)(3) organizations).

[241] If, under any such measure, the organization's debt management plan services exceed 25 percent of the organization's total activities, the organization is treated as exceeding the 25-percent limit. For example, an organization that devotes 30 percent of its total staff time to debt management plan services is regarded as exceeding the 25-percent limit, even if the organization devotes less than 15 percent of its total financial resources to debt management plan services.

Debt management plan services treated as an unrelated trade or business

Under the proposal, debt management plan services as treated as an unrelated trade or business for purposes of the tax on income from an unrelated trade or business to the extent such services are not substantially related to the provision of credit counseling services to a consumer or are provided by an organization that is not a credit counseling organization.

Definitions

Credit counseling services

Credit counseling services are (a) the providing educational information to the general public on budgeting, personal finance, financial literacy, saving and spending practices, and the sound use of consumer credit; (b) the assisting of individuals and families with financial problems by providing them with counseling; or (c) any combination of such activities.

Debt management plan services

Debt management plan services are services related to the repayment, consolidation, or restructuring of a consumer's debt, and includes the negotiation with creditors of lower interest rates, the waiver or reduction of fees, and the marketing and processing of debt management plans.

Credit repair organization

A credit repair organization is one defined in section 403(3) of the Consumer Credit Protection Act, 15 U.S.C. 1679a(3), without regard to subparagraph (B) thereof.

Related person

A person is treated as related to another person if such person bears a relationship to such other person described in section 4958(f)(1)(B), section 4958(f)(1)(C), or section 4946(a)(1)(H)(i).

Effective Date

For organizations that are not described in section 501(c)(3) or section 501(c)(4) prior to the date of enactment or that are so described but did not provide credit counseling services prior to such date, the proposal is effective for taxable years beginning after the date of enactment. For organizations described in section 501(c)(3) or 501(c)(4) prior to the date of enactment that provided credit counseling services prior to such date, the proposal is effective for taxable years beginning 1 year after the date of enactment. The Secretary has authority to request information from an organization providing credit counseling services to ensure that the organization is in compliance with the proposal.

20. Impose loan and redemption requirements on pooled financing bonds

Present Law

In general

Interest on bonds issued by State and local governments generally is excluded from gross income for Federal income tax purposes if the proceeds of such bonds are used to finance direct activities of governmental units or if such bonds are repaid with revenues of governmental units. These bonds are called "governmental bonds." Interest on State or local government bonds issued to finance certain activities of private persons is taxable unless a specific exception applies. These bonds are called "private activity bonds." The exclusion from income for State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes. In addition, the Code imposes requirements that apply to all tax-exempt State and local bonds. Arbitrage restrictions, for example, limit the ability of issuers to profit from investment of tax-exempt bond proceeds. The Code also imposes requirements that only apply to specific types of bond issues. For instance, pooled financing bonds (defined below) are not tax-exempt unless the issuer meets certain requirements regarding the expected use of proceeds.

Pooled financing bond restrictions

At times, State or local bonds are issued to provide financing for the benefit of a third party (a "conduit borrower"). Pooled financing bonds are issues in which the proceeds are used to make or finance loans to two or more conduit borrowers, unless the conduit loans are to be used to finance a single project.[242] The Code imposes several requirements on pooled financing bonds if more than $5 million of proceeds are expected to be used to make loans to conduit borrowers. For purposes of these rules, a pooled financing bond does not include certain private activity bonds.[243]

A pooled financing bond is not tax-exempt unless the issuer reasonably expects that at least 95 percent of the net proceeds will be lent to ultimate borrowers by the end of the third year after the date of issue. The term "net proceeds" is defined to mean the proceeds of the issue less the following amounts: (1) proceeds used to finance issuance costs; (2) proceeds necessary to pay interest on the bonds during a three-year period; and (3) amounts in reasonably required reserves.[244]

An issuer's past experience regarding loan origination is a criterion upon which the reasonableness of the issuer's expectations can be based. As an additional requirement for tax exemption, all legal and underwriting costs associated with the issuance of pooled financing

[242] Treas. Reg. sec. 1.150-1(b).

[243] Sec. 149(f)(4)(B).

[244] Sec. 149(f)(2)(C).

bonds may not be contingent and must be substantially paid within 180 days of the date of issuance.

Arbitrage restrictions on tax-exempt bonds

To prevent the issuance of more Federally subsidized tax-exempt bonds than necessary; the tax exemption for State and local bonds does not apply to any arbitrage bond.[245] An arbitrage bond is defined as any bond that is part of an issue if any proceeds of the issue are reasonably expected to be used (or intentionally are used) to acquire higher yielding investments or to replace funds that are used to acquire higher yielding investments. In general, arbitrage profits may be earned only during specified periods (e.g., defined "temporary periods") before funds are needed for the purpose of the borrowing or on specified types of investments (e.g., "reasonably required reserve or replacement funds"). Subject to limited exceptions, investment profits that are earned during these periods or on such investments must be rebated to the Federal Government ("arbitrage rebate").

The Code contains several exceptions to the arbitrage rebate requirement, including an exception for bonds issued by small governments (the "small issuer exception"). For this purpose, small governments are defined as general purpose governmental units that issue no more than $5 million of tax-exempt governmental bonds in a calendar year.[246]

Pooled financing bonds are subject to the arbitrage restrictions that apply to all tax-exempt bonds, including arbitrage rebate. Under certain circumstances, however, small governments may issue pooled financing bonds without those bonds counting towards the determination of whether the issuer qualifies for the small issuer exception to arbitrage rebate. In the case of a pooled financing bond where the ultimate borrowers are governmental units with general taxing powers not subordinate to the issuer of the pooled bond, the pooled bond does not count against the issuer's $5 million limitation, provided the issuer is not a borrower from the pooled bond.[247] However, the issuer of the pooled financing bond remains subject to the arbitrage rebate requirement for unloaned proceeds.[248]

Description of Proposal

In general

The proposal imposes new requirements on pooled financing bonds as a condition of tax-exemption. First, the proposal imposes a written loan commitment requirement to restrict the issuance of pooled bonds where potential borrowers have not been identified ("blind pools"). Second, in addition to the current three-year expectations requirement, the issuer must

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[245] Secs. 103(a) and (b)(2).

[246] The $5 million limit is increased to $15 million if at least $10 million of the bonds are used to finance public schools.

[247] Sec. 148(f)(4)(D)(ii)(II).

[248] Treas. Reg. sec. 1.148-8(d)(1).

reasonably expect that at least 50 percent of the net proceeds of the pooled financing bond will be lent to borrowers one year after the date of issue. Third, the proposal requires the redemption of outstanding bonds with proceeds that are not loaned to borrowers within the expected loan origination periods. Finally, the proposal eliminates the rule allowing an issuer of pooled financing bonds to disregard the pooled financing bonds for purposes of determining whether the issuer qualifies for the small issuer exception to rebate.

Loan commitments

Under the proposal, interest on a pooled financing bond is tax exempt only if the issuer obtains written commitments with ultimate borrowers for loans equal to at least 50 percent of the net proceeds of the pooled bond prior to issuance. For purposes of the proposal, a loan commitment exists only if: (a) the issuer is committed to lend bond proceeds to the borrower identified in the commitment, and (b) the borrower has applied for, and agreed to execute, a loan in an amount certain to finance a specifically identified project and, as part of that application, has paid a nonrefundable commitment fee in an amount that is commensurate with fees customarily paid for similar loan commitments.

The loan commitment requirement does not apply to bonds issued by States (or an integral part of a State) to provide loans to subordinate governmental units or State entities created to provide financing for water-infrastructure projects through the Federally-sponsored State Revolving Fund Program.

Loan origination expectations

The proposal imposes new reasonable expectations requirements for loan originations. The issuer must expect that at least 50 percent of the net proceeds of the pooled financing bond will be lent to ultimate borrowers one year after the date of issue. This is in addition to the present-law requirement that at least 95 percent of the net proceeds will be lent to ultimate borrowers by the end of the third year after the date of issue.

Redemption requirement

Under the proposal, if bond proceeds are not loaned to borrowers within prescribed periods, outstanding bonds equal to the amount of proceeds that were not loaned within the required period must be redeemed within 90 days. The bond redemption requirement applies with respect to proceeds that are unloaned as of expiration of the one-year and three-year loan origination periods. For example, if an amount equal to 45 percent of the net proceeds of an issue are used to make loans to ultimate borrowers as of one year after the bonds are issued, an amount equal to five percent of the net proceeds of the issue is no longer available for lending and must be used to redeem bonds within the following 90-day period. Similarly, if only 85 percent of the net proceeds of the issue are used to make qualifying loans (or to redeem bonds) as of three years after the bonds are issued, 10 percent of the remaining net proceeds is no longer available for lending and must be used to redeem bonds within the following 90-day period.

Small issuer exception

The proposal eliminates the rule disregarding pooled financing bonds from the issuer's $5,000,000 annual limitation for purposes of the small issuer exception to arbitrage rebate.

Effective Date

The proposal is effective for bonds issued after the date of enactment.

21. Amend information reporting requirements to include interest on tax-exempt bonds

Present Law

Tax-exempt bonds

Generally, gross income does not include interest on State or local bonds. State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds the proceeds of which are primarily used to finance governmental facilities or the debt is repaid with governmental funds. Private activity bonds are bonds in which the State or local government serves as a conduit providing financing to nongovernmental persons (e.g., private businesses or individuals). The exclusion from income for State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain purposes ("qualified private activity bonds") permitted by the Code.

Tax-exempt interest reporting by taxpayers

The Code provides that every person required to file a return must report the amount of tax-exempt interest received or accrued during any taxable year. The amount of tax-exempt interest received is relevant to determining tax liability in a number of instances, despite the general exclusion from income. For example, the interest income from qualified private activity bonds (other than qualified 501(c)(3) bonds) issued after August 7, 1986, is a preference item for purposes of calculating the alternative minimum tax ("AMT").[249] Tax-exempt interest also is relevant for determining eligibility for the earned income credit (the "EIC") and the amount of Social Security benefits includable in gross income. Moreover, determining includable Social Security benefits is necessary for calculating either adjusted or modified adjusted gross income under several Code sections.

Information reporting by payors

The Code generally requires every person who makes payments of interest aggregating $10 or more or receives payments of interest as a nominee and who makes payments aggregating $10 or more to file an information return setting forth the amount of interest payments for the

[249] Sec. 57(a)(5). Special rules apply to exclude refundings of bonds issued before August 8, 1986, and certain bonds issued before September 1, 1986.

calendar year and the name, address, and TIN[250] of the person to whom interest is paid. Treasury regulations prescribe the form and manner for filing interest payment information returns. Treasury regulations require the reporting of the account or serial number, or other identifying information with respect to obligations on which interest is paid. The regulations also require that every person acting as a middleman (e.g., a broker) file information returns for the calendar year. Penalties are imposed for failures to file interest payment information returns or payee statements. Treasury regulations also impose recordkeeping requirements on any person required to file information returns. The Code excludes interest paid on tax-exempt bonds from interest reporting requirements.[251]

Description of Proposal

Under the proposal, interest paid on tax-exempt bonds is subject to information reporting in the same manner as interest paid on taxable obligations.

Effective Date

The proposal is effective for interest paid after December 31, 2005.

22. Modification of credit for fuel from a non-conventional source

Present Law

Certain fuels produced from "non-conventional sources" and sold to unrelated parties are eligible for an income tax credit equal to $3 (generally adjusted for inflation)[252] per barrel or Btu oil barrel equivalent ("non-conventional source fuel credit"). Qualified fuels must be produced within the United States.

Qualified fuels include:

- oil produced from shale and tar sands;
- gas produced from geopressured brine, Devonian shale, coal seams, tight formations, or biomass; and
- liquid, gaseous, or solid synthetic fuels produced from coal (including lignite).

Generally, the non-conventional source fuel credit has expired, except for certain biomass gas and synthetic fuels sold before January 1, 2008, and produced at facilities placed in service

[250] The taxpayer's identification number, generally, for individuals is the taxpayer's social security number. Sec. 7701(a)(41).

[251] Sec. 6049(b)(2)(B).

[252] Generally, the value of the credit in 2004 was $6.56 per barrel-of-oil equivalent produced, which is approximately $1.16 per thousand cubic feet of natural gas. The credit for coke or coke gas is indexed for inflation using 2004 as the base year instead of 1979.

after December 31, 1992, and before July 1, 1998. The non-conventional source fuel credit provision also includes a credit for producing coke or coke gas at qualified facilities. The amount of credit-eligible coke produced at any one facility may not exceed an average barrel-of-oil equivalent of 4,000 barrels per day.

The non-conventional source fuel credit is reduced (but not below zero) over a $6 phase-out period as the reference price for oil exceeds $23.50 per barrel, adjusted for inflation. The reference price is the Secretary's estimate of the annual average wellhead price per barrel for all domestic crude oil. The credit did not phase-out for 2004 because the reference price for that year of $36.75 did not exceed the inflation adjusted threshold of $51.35.

Beginning with taxable years ending after December 31, 2005, the non-conventional source fuel credit is part of the general business credit (sec. 38).

Description of Proposal

The proposal modifies the manner in which the phase-out of the non-conventional source fuel credit is calculated. Specifically, in calculating the phase-out of the credit rather than relying upon the reference price for the calendar year in which the sale of qualified non-conventional fuel occurs, the proposal uses the reference price for the calendar year preceding the calendar year in which the sale occurs. Thus, under the proposal, whether the credit is phased out in 2005 is determined by reference to 2004 wellhead prices, whether the credit is phased out in 2006 is determined by reference to 2005 wellhead prices, and so on. In addition, the proposal repeals the phase-out limitation entirely for coke and coke gas produced under section 45K(g).

The proposal eliminates the inflation adjustment for all fuels other than coke and coke gas for 2005, 2006, and 2007. Thus, the current credit amount of $6.56 per barrel of oil equivalent will remain in effect through the December 31, 2007. Under the proposal, the credit amount of $3 per barrel of oil equivalent for coke and coke gas produced under section 45K(g) would continue to be adjusted for inflation using 2004 as the base year.

Finally, the proposal clarifies that qualifying facilities producing coke or coke gas under section 45K(g) do not include facilities that produce petroleum-based coke or coke gas.

Effective Date

The proposal is effective for fuel sold after December 31, 2004.

23. Modification of individual estimated tax safe harbor

Present Law

An individual taxpayer generally is subject to an addition to tax for any underpayment of estimated tax. An individual generally does not have an underpayment of estimated tax if he or she makes timely estimated tax payments equal to the lesser of: (1) 90 percent of the tax shown on the current year's return or (2) 100 percent of the prior year's tax. For taxpayers with a prior year's AGI above $150,000, however, the rule that allows payment of 100 percent of prior year's tax is modified. Those taxpayers with AGI above $150,000 generally must make estimated payments equal to the lesser of (1) 90 percent of the tax shown on the current year's return or (2) 110 percent of the prior year's tax.

Description of Proposal

First, the proposal provides that taxpayers with prior year's AGI above $150,000 who make estimated tax payments based on prior year's tax must do so based on 119 percent of prior year's tax for estimated tax payments made for taxable year 2006. That percentage will revert back to 110 percent for taxable years 2007 and thereafter.

Effective Date

The proposal is effective for estimated tax payments made for taxable years beginning after December 31, 2005.

24. Time for payment of corporate estimated taxes

Present Law

In general, corporations are required to make quarterly estimated tax payments of their income tax liability. For a corporation whose taxable year is a calendar year, these estimated tax payments must be made by April 15, June 15, September 15, and December 15.

Description of Proposal

With respect to corporate estimated tax payments due on September 15, 2010, 3 percent is required to be paid on October 1, 2010.

Effective Date

The proposal is effective on the date of enactment.

25. Extension and modification of new markets tax credit

Present Law

Section 45D provides a new markets tax credit for qualified equity investments made to acquire stock in a corporation, or a capital interest in a partnership, that is a qualified community development entity ("CDE").[253] The amount of the credit allowable to the investor (either the original purchaser or a subsequent holder) is (1) a five-percent credit for the year in which the equity interest is purchased from the CDE and for each of the following two years, and (2) a six-percent credit for each of the following four years. The credit is determined by applying the applicable percentage (five or six percent) to the amount paid to the CDE for the investment at

[253] Section 45D was added by section 121(a) of the Community Renewal Tax Relief Act of 2000, P.L. No. 106-554 (December 21, 2000).

its original issue, and is available for a taxable year to the taxpayer who holds the qualified equity investment on the date of the initial investment or on the respective anniversary date that occurs during the taxable year. The credit is recaptured if at any time during the seven-year period that begins on the date of the original issue of the investment the entity ceases to be a qualified CDE, the proceeds of the investment cease to be used as required, or the equity investment is redeemed.

A qualified CDE is any domestic corporation or partnership: (1) whose primary mission is serving or providing investment capital for low-income communities or low-income persons; (2) that maintains accountability to residents of low-income communities by their representation on any governing board of or any advisory board to the CDE; and (3) that is certified by the Secretary as being a qualified CDE. A qualified equity investment means stock (other than nonqualified preferred stock) in a corporation or a capital interest in a partnership that is acquired directly from a CDE for cash, and includes an investment of a subsequent purchaser if such investment was a qualified equity investment in the hands of the prior holder. Substantially all of the investment proceeds must be used by the CDE to make qualified low-income community investments. For this purpose, qualified low-income community investments include: (1) capital or equity investments in, or loans to, qualified active low-income community businesses; (2) certain financial counseling and other services to businesses and residents in low-income communities; (3) the purchase from another CDE of any loan made by such entity that is a qualified low-income community investment; or (4) an equity investment in, or loan to, another CDE.

A "low-income community" is a population census tract with either (1) a poverty rate of at least 20 percent or (2) median family income which does not exceed 80 percent of the greater of metropolitan area median family income or statewide median family income (for a non-metropolitan census tract, does not exceed 80 percent of statewide median family income). In the case of a population census tract located within a high migration rural county, low-income is defined by reference to 85 percent (rather than 80 percent) of statewide median family income. For this purpose, a high migration rural county is any county that, during the 20-year period ending with the year in which the most recent census was conducted, has a net out-migration of inhabitants from the county of at least 10 percent of the population of the county at the beginning of such period.

The Secretary has the authority to designate "targeted populations" as low-income communities for purposes of the new markets tax credit. For this purpose, a "targeted population" is defined by reference to section 103(20) of the Riegle Community Development and Regulatory Improvement Act of 1994 (12 U.S.C. 4702(20)) to mean individuals, or an identifiable group of individuals, including an Indian tribe, who (A) are low-income persons; or (B) otherwise lack adequate access to loans or equity investments. Under such Act, "low-income" means (1) for a targeted population within a metropolitan area, less than 80 percent of the area median family income; and (2) for a targeted population within a non-metropolitan area, less than the greater of 80 percent of the area median family income or 80 percent of the statewide non-metropolitan area median family income.[254] Under such Act, a targeted

[254] 12. U.S.C. 4702(17) (defines "low-income" for purposes of 12. U.S.C. 4702(20)).

population is not required to be within any census tract. In addition, a population census tract with a population of less than 2,000 is treated as a low-income community for purposes of the credit if such tract is within an empowerment zone, the designation of which is in effect under section 1391, and is contiguous to one or more low-income communities.

A qualified active low-income community business is defined as a business that satisfies, with respect to a taxable year, the following requirements: (1) at least 50 percent of the total gross income of the business is derived from the active conduct of trade or business activities in any low-income community; (2) a substantial portion of the tangible property of such business is used in a low-income community; (3) a substantial portion of the services performed for such business by its employees is performed in a low-income community; and (4) less than five percent of the average of the aggregate unadjusted bases of the property of such business is attributable to certain financial property or to certain collectibles.

The maximum annual amount of qualified equity investments is capped at $2.0 billion per year for calendar years 2004 and 2005, and at $3.5 billion per year for calendar years 2006 and 2007.

Description of Proposal

The proposal permits for 2008 a $3.5 billion maximum annual amount of qualified equity investments. The proposal also requires that the Secretary prescribe regulations to ensure that non-metropolitan counties receive a proportional allocation of qualified equity investments.

Effective Date

The proposal is effective on the date of enactment.

26. Expansion of Hope and Lifetime Learning Credits for students in the Gulf Recovery Zone

Present Law

Hope credit

The Hope credit is a nonrefundable credit of up to $1,500 per student per year for qualified tuition and related expenses paid for the first two years of the student's post-secondary education in a degree or certificate program.[255] The Hope credit rate is 100 percent on the first $1,000 of qualified tuition and related expenses, and 50 percent on the next $1,000 of qualified tuition and related expenses. The Hope credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified adjusted gross income between $43,000 and $53,000

[255] Sec. 25A. The Hope credit generally may not be claimed against a taxpayer's alternative minimum tax liability. However, the credit may be claimed against a taxpayer's alternative minimum tax liability for taxable years beginning prior to January 1, 2006.

($87,000 and $107,000 for married taxpayers filing a joint return) for 2005.[256] The first adjustment to these amounts as a result of inflation is expected in 2006. Thus, for example, an eligible student who incurs $1,000 of qualified tuition and related expenses is eligible (subject to the adjusted gross income phaseout) for a $1,000 Hope credit. If an eligible student incurs $2,000 or more of qualified tuition and related expenses, then he or she is eligible for a $1,500 Hope credit.

The qualified tuition and related expenses must be incurred on behalf of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer. The Hope credit is available with respect to an individual student for two taxable years, provided that the student has not completed the first two years of post-secondary education before the beginning of the second taxable year.

The Hope credit is available in the taxable year the expenses are paid, subject to the requirement that the education is furnished to the student during that year or during the first three months of the next year. Qualified tuition and related expenses paid with the proceeds of a loan generally are eligible for the Hope credit. The repayment of a loan itself is not a qualified tuition or related expense.

A taxpayer may claim the Hope credit with respect to an eligible student who is not the taxpayer or the taxpayer's spouse (e.g., in cases in which the student is the taxpayer's child) only if the taxpayer claims the student as a dependent for the taxable year for which the credit is claimed. If a student is claimed as a dependent, the student is not entitled to claim a Hope credit for that taxable year on the student's own tax return. If a parent (or other taxpayer) claims a student as a dependent, any qualified tuition and related expenses paid by the student are treated as paid by the parent (or other taxpayer) for purposes of determining the amount of qualified tuition and related expenses paid by such parent (or other taxpayer) under the provision. In addition, for each taxable year, a taxpayer may elect either the Hope credit, the Lifetime Learning credit (described below), or the section 222 deduction for qualified tuition and related expenses with respect to an eligible student.

The Hope credit is available for "qualified tuition and related expenses," which include tuition and fees (excluding nonacademic fees) required to be paid to an eligible educational institution as a condition of enrollment or attendance of an eligible student at the institution. Charges and fees associated with meals, lodging, insurance, transportation, and similar personal, living, or family expenses are not eligible for the credit. The expenses of education involving sports, games, or hobbies are not qualified tuition and related expenses unless this education is part of the student's degree program.

Qualified tuition and related expenses generally include only out-of-pocket expenses. Qualified tuition and related expenses do not include expenses covered by employer-provided educational assistance and scholarships that are not required to be included in the gross income

[256] The adjusted gross income phase-out ranges are indexed for inflation. Also, each of the $1,000 amounts of qualified tuition and related expenses to which the 100-percent credit rate and 50 percent credit rate apply are indexed for inflation, with the amount rounded down to the next lowest multiple of $100.

of either the student or the taxpayer claiming the credit. Thus, total qualified tuition and related expenses are reduced by any scholarship or fellowship grants excludable from gross income under section 117 and any other tax-free educational benefits received by the student (or the taxpayer claiming the credit) during the taxable year. The Hope credit is not allowed with respect to any education expense for which a deduction is claimed under section 162 or any other section of the Code.

An eligible student for purposes of the Hope credit is an individual who is enrolled in a degree, certificate, or other program (including a program of study abroad approved for credit by the institution at which such student is enrolled) leading to a recognized educational credential at an eligible educational institution. The student must pursue a course of study on at least a half-time basis. A student is considered to pursue a course of study on at least a half-time basis if the student carries at least one half the normal full-time work load for the course of study the student is pursuing for at least one academic period that begins during the taxable year. To be eligible for the Hope credit, a student must not have been convicted of a Federal or State felony consisting of the possession or distribution of a controlled substance.

Eligible educational institutions generally are accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also are eligible educational institutions. In order to qualify as an eligible educational institution, an institution must be eligible to participate in Department of Education student aid programs.

For taxable years beginning in 2004 and 2005, the Hope credit offsets the alternative minimum tax. For taxable years thereafter, the Hope credit does not offset the alternative minimum tax.

Effective for taxable years beginning after December 31, 2010, the changes to the Hope credit made by EGTRRA no longer apply. The EGTRRA change scheduled to expire is the change that permitted a taxpayer to claim a Hope credit in the same year that he or she claimed an exclusion from an education savings account. Thus, after 2010, a taxpayer cannot claim a Hope credit in the same year he or she claims an exclusion from an education savings account.

Lifetime Learning credit

Individual taxpayers are allowed to claim a nonrefundable credit, the Lifetime Learning credit, equal to 20 percent of qualified tuition and related expenses incurred during the taxable year on behalf of the taxpayer, the taxpayer's spouse, or any dependents.[257] Up to $10,000 of qualified tuition and related expenses per taxpayer return are eligible for the Lifetime Learning credit (i.e., the maximum credit per taxpayer return is $2,000). In contrast with the Hope credit, the maximum credit amount is not indexed for inflation.

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[257] Sec. 25A. The Lifetime Learning credit generally may not be claimed against a taxpayer's alternative minimum tax liability. However, the credit may be claimed against a taxpayer's alternative minimum tax liability for taxable years beginning prior to January 1, 2006.

In contrast to the Hope credit, a taxpayer may claim the Lifetime Learning credit for an unlimited number of taxable years. Also in contrast to the Hope credit, the maximum amount of the Lifetime Learning credit that may be claimed on a taxpayer's return will not vary based on the number of students in the taxpayer's family -- that is, the Hope credit is computed on a per student basis, while the Lifetime Learning credit is computed on a family-wide basis. The Lifetime Learning credit amount that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified adjusted gross income between $43,000 and $53,000 ($87,000 and $107,000 for married taxpayers filing a joint return) for 2005. These phaseout ranges are the same as those for the Hope credit, and are similarly indexed for inflation.

The Lifetime Learning credit is available in the taxable year the expenses are paid, subject to the requirement that the education is furnished to the student during that year or during the first three months of the next year. Qualified tuition and related expenses paid with the proceeds of a loan generally are eligible for the Lifetime Learning credit. As with the Hope credit, repayment of a loan is not a qualified tuition expense.

As with the Hope credit, a taxpayer may claim the Lifetime Learning credit with respect to a student who is not the taxpayer or the taxpayer's spouse (e.g., in cases in which the student is the taxpayer's child) only if the taxpayer claims the student as a dependent for the taxable year for which the credit is claimed. If a student is claimed as a dependent by the parent or other taxpayer, the student may not claim the Lifetime Learning credit for that taxable year on the student's own tax return. If a parent (or other taxpayer) claims a student as a dependent, any qualified tuition and related expenses paid by the student are treated as paid by the parent (or other taxpayer) for purposes of the provision.

A taxpayer may claim the Lifetime Learning credit for a taxable year with respect to one or more students, even though the taxpayer also claims a Hope credit for that same taxable year with respect to other students. If, for a taxable year, a taxpayer claims a Hope credit with respect to a student, then the Lifetime Learning credit is not available with respect to that same student for that year (although the Lifetime Learning credit may be available with respect to that same student for other taxable years). As with the Hope credit, a taxpayer may not claim the Lifetime Learning credit and also claim the section 222 deduction for qualified tuition and related expenses.

As with the Hope credit, the Lifetime Learning credit is available for "qualified tuition and related expenses," which include tuition and fees (excluding nonacademic fees) required to be paid to an eligible educational institution as a condition of enrollment or attendance of a student at the institution. Eligible higher education institutions are defined in the same manner for purposes of both the Hope and Lifetime Learning credits. Charges and fees associated with meals, lodging, insurance, transportation, and similar personal, living or family expenses are not eligible for the credit. The expenses of education involving sports, games, or hobbies are not qualified tuition expenses unless this education is part of the student's degree program, or the education is undertaken to acquire or improve the job skills of the student.

In contrast to the Hope credit, qualified tuition and related expenses for purposes of the Lifetime Learning credit include tuition and fees incurred with respect to undergraduate or graduate-level courses.[258] Additionally, in contrast to the Hope credit, the eligibility of a student for the Lifetime Learning credit does not depend on whether the student has been convicted of a Federal or State felony consisting of the possession or distribution of a controlled substance.

As with the Hope credit, qualified tuition and fees generally include only out-of-pocket expenses. Qualified tuition and fees do not include expenses covered by employer-provided educational assistance and scholarships that are not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total qualified tuition and fees are reduced by any scholarship or fellowship grants excludable from gross income under section 117 and any other tax-free educational benefits received by the student during the taxable year (such as employer-provided educational assistance excludable under section 127). The Lifetime Learning credit is not allowed with respect to any education expense for which a deduction is claimed under section 162 or any other section of the Code.

For taxable years beginning in 2004 and 2005, the Lifetime Learning credit offsets the alternative minimum tax. For taxable years thereafter, the credit does not offset the alternative minimum tax.

Effective for taxable years beginning after December 31, 2010, the changes to the Lifetime Learning credit made by EGTRRA no longer apply. The EGTRRA change scheduled to expire is the change that permitted a taxpayer to claim a Lifetime Learning credit in the same year that he or she claimed an exclusion from an education savings account. Thus, after 2010, taxpayers cannot claim a Lifetime Learning credit in the same year he or she claims an exclusion from an education savings account.

Description of Proposal

The proposal temporarily expands the Hope and Lifetime Learning credits for students attending (i.e., enrolled and paying tuition at) an eligible education institution located in the Gulf Recovery Zone.

Under the proposal, the Hope credit is increased to 100 percent of the first $2,000 in qualified tuition and related expenses and 50 percent on the next $2,000 of qualified tuition and related expenses for a maximum credit of $3,000 per student. The Lifetime Learning credit rate is increased from 20 percent to 40 percent. The proposal expands the definition of qualified expenses to include expenses associated with books, transportation, and room and board (as defined in section 529).

The proposal applies to taxable years beginning in 2005 or 2006.

[258] As explained above, the Hope credit is available only with respect to the first two years of a student's undergraduate education.

Effective Date

The proposal is effective on the date of enactment.

27. Restructure New York Liberty Zone tax incentives

Present Law

In general

Present law includes a number of incentives to invest in property located in the New York Liberty Zone ("NYLZ"), which is the area located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan in the City of New York, New York. These incentives were enacted following the terrorist attack in New York City on September 11, 2001.[259]

Special depreciation allowance for qualified New York Liberty Zone property

Section 1400L(b) allows an additional first-year depreciation deduction equal to 30 percent of the adjusted basis of qualified NYLZ property.[260] In order to qualify, property generally must be placed in service on or before December 31, 2006 (December 31, 2009 in the case of nonresidential real property and residential rental property).

The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service. A taxpayer is allowed to elect out of the additional first-year depreciation for any class of property for any taxable year.

In order for property to qualify for the additional first-year depreciation deduction, it must meet all of the following requirements. First, the property must be property to which the general rules of the Modified Accelerated Cost Recovery System ("MACRS")[261] apply with (1) an applicable recovery period of 20 years or less, (2) water utility property (as defined in section 168(e)(5)), (3) certain nonresidential real property and residential rental property, or (4)

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[259] In addition to the NYLZ provisions described above, other NYLZ incentives are provided: (1) $8 billion of tax-exempt private activity bond financing for certain nonresidential real property, residential rental property and public utility property is authorized to be issued after March 9, 2002, and before January 1, 2010; and (2) $9 billion of additional tax-exempt advance refunding bonds is available after March 9, 2002, and before January 1, 2006, with respect to certain State or local bonds outstanding on September 11, 2001.

[260] The amount of the additional first-year depreciation deduction is not affected by a short taxable year.

[261] A special rule precludes the additional first-year depreciation deduction for property that is required to be depreciated under the alternative depreciation system of MACRS.

computer software other than computer software covered by section 197. A special rule precludes the additional first-year depreciation under this provision for (1) qualified NYLZ leasehold improvement property[262] and (2) property eligible for the additional first-year depreciation deduction under section 168(k) (i.e., property is eligible for only one 30 percent additional first-year depreciation). Second, substantially all of the use of such property must be in the NYLZ. Third, the original use of the property in the NYLZ must commence with the taxpayer on or after September 11, 2001. Finally, the property must be acquired by purchase[263] by the taxpayer after September 10, 2001 and placed in service on or before December 31, 2006. For qualifying nonresidential real property and residential rental property the property must be placed in service on or before December 31, 2009 in lieu of December 31, 2006. Property will not qualify if a binding written contract for the acquisition of such property was in effect before September 11, 2001.[264]

Nonresidential real property and residential rental property is eligible for the additional first-year depreciation only to the extent such property rehabilitates real property damaged, or replaces real property destroyed or condemned as a result of the terrorist attacks of September 11, 2001.

Property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer qualifies for the additional first-year depreciation deduction if the taxpayer begins the manufacture, construction, or production of the property after September 10, 2001, and the property is placed in service on or before December 31, 2006[265] (and all other requirements are met). Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer.

Depreciation of New York Liberty Zone leasehold improvements

Generally, depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period assigned to the property is longer than the term of the lease.[266] This rule applies regardless of whether the lessor or the

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[262] Qualified NYLZ leasehold improvement property is defined in another provision. Leasehold improvements that do not satisfy the requirements to be treated as "qualified NYLZ leasehold improvement property" maybe eligible for the 30 percent additional first-year depreciation deduction (assuming all other conditions are met).

[263] For purposes of this provision, purchase is defined as under section 179(d).

[264] Property is not precluded from qualifying for the additional first-year depreciation merely because a binding written contract to acquire a component of the property is in effect prior to September 11, 2001.

[265] December 31, 2009 with respect to qualified nonresidential real property and residential rental property.

[266] Sec. 168(i)(8). The Tax Reform Act of 1986 modified the Accelerated Cost Recovery System ("ACRS") to institute MACRS. Prior to the adoption of ACRS by the Economic Recovery Tax Act of

lessee places the leasehold improvements in service.[267] If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement generally is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement is placed in service.[268]

A special rule exists for qualified NYLZ leasehold improvement property, which is recovered over five years using the straight-line method. The term qualified NYLZ leasehold improvement property means property defined in section 168(e)(6) that is acquired and placed in service after September 10, 2001, and before January 1, 2007 (and not subject to a binding contract on September 10, 2001), in the NYLZ. For purposes of the alternative depreciation system, the property is assigned a nine-year recovery period. A taxpayer may elect out of the 5-year (and 9-year) recovery period for qualified NYLZ leasehold improvement property.

Increased section 179 expensing for qualified New York Liberty Zone property

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct the cost of qualifying property. For taxable years beginning in 2003 through 2007, a taxpayer may deduct up to $100,000 of the cost of qualifying property placed in service for the taxable year. In general, qualifying property for this purpose is defined as depreciable tangible personal property (and certain computer software) that is purchased for use in the active conduct of a trade or business. The $100,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $400,000. The $100,000 and $400,000 amounts are indexed for inflation.

For taxable years beginning in 2008 and thereafter, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. In general, qualifying property for this purpose is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business.

1981, taxpayers were allowed to depreciate the various components of a building as separate assets with separate useful lives. The use of component depreciation was repealed upon the adoption of ACRS. The Tax Reform Act of 1986 also denied the use of component depreciation under MACRS.

[267] Former sections 168(f)(6) and 178 provided that, in certain circumstances, a lessee could recover the cost of leasehold improvements made over the remaining term of the lease. The Tax Reform Act of 1986 repealed these provisions.

[268] Secs. 168(b)(3), (c), (d)(2), and (i)(6). If the improvement is characterized as tangible personal property, ACRS or MACRS depreciation is calculated using the shorter recovery periods, accelerated methods, and conventions applicable to such property. The determination of whether improvements are characterized as tangible personal property or as nonresidential real property often depends on whether or not the improvements constitute a “structural component” of a building (as defined by Treas. Reg. sec. 1.48-1(e)(1)). See, e.g., *Metro National Corp v. Commissioner*, 52 TCM (CCH) 1440 (1987); *King Radio Corp Inc. v. U.S.*, 486 F.2d 1091 (10th Cir. 1973); *Mallinckrodt, Inc. v. Commissioner*, 778 F.2d 402 (8th Cir. 1985) (with respect to various leasehold improvements).

The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations). No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179.

The amount a taxpayer can deduct under section 179 is increased for qualifying property used in the NYLZ. Specifically, the maximum dollar amount that may be deducted under section 179 is increased by the lesser of (1) $35,000 or (2) the cost of qualifying property placed in service during the taxable year. This amount is in addition to the amount otherwise deductible under section 179.

Qualifying property for purposes of the NYLZ provision means section 179 property[269] purchased and placed in service by the taxpayer after September 10, 2001 and before January 1, 2007, where (1) substantially all of the use of such property is in the NYLZ in the active conduct of a trade or business by the taxpayer in the NYLZ, and (2) the original use of which in the NYLZ commences with the taxpayer after September 10, 2001.[270]

The phase-out range for the section 179 deduction attributable to NYLZ property is applied by taking into account only 50 percent of the cost of NYLZ property that is section 179 property. Also, no general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179.

The provision is effective for property placed in service after September 10, 2001 and before January 1, 2007.

Extended replacement period for New York Liberty Zone involuntary conversions

A taxpayer may elect not to recognize gain with respect to property that is involuntarily converted if the taxpayer acquires within an applicable period (the "replacement period") property similar or related in service or use (section 1033). If the taxpayer does not replace the converted property with property similar or related in service or use, then gain generally is recognized. If the taxpayer elects to apply the rules of section 1033, gain on the converted property is recognized only to the extent that the amount realized on the conversion exceeds the cost of the replacement property. In general, the replacement period begins with the date of the disposition of the converted property and ends two years after the close of the first taxable year in which any part of the gain upon conversion is realized.[271] The replacement period is extended

[269] As defined in sec. 179(d)(1).

[270] See Rev. Proc. 2002-33, 2002-20 I.R.B. 963 (May 20, 2002), for procedures on claiming the increased section 179 expensing deduction by taxpayers who filed their tax returns before June 1, 2002.

[271] Section 1033(a)(2)(B).

to three years if the converted property is real property held for the productive use in a trade or business or for investment.[272]

The replacement period is extended to five years with respect to property that was involuntarily converted within the NYLZ as a result of the terrorist attacks that occurred on September 11, 2001. However, the five-year period is available only if substantially all of the use of the replacement property is in New York City. In all other cases, the present-law replacement period rules continue to apply.

Description of Proposal

Repeal of certain NYLZ incentives

The proposal repeals the four NYLZ incentives relating to the additional first-year depreciation allowance of 30 percent, the five-year depreciation of leasehold improvements, the additional section 179 expensing, and the extended replacement period for involuntary conversions.[273]

Creation of New York Liberty Zone Tax Credits

The proposal provides a credit against tax imposed (other than taxes of section 3111(a), 3403, or subtitle D) paid or incurred by any governmental unit of the State of New York and the City of New York equal to the lesser of (1) the total expenditures during such year by such governmental unit for qualifying projects, or (2) the amount allocated to such governmental unit for such calendar year.

Qualifying projects means any transportation infrastructure project, including highways, mass transit systems, railroads, airports, ports, and waterways, in or connecting with the New York Liberty Zone, which is designated as a qualifying project by the Governor of the State of New York and the Mayor of the City of New York.

The aggregate limit that may be allocated for all calendar years in the credit period is two billion dollars. The annual limit for any calendar year in the credit period shall not exceed the sum of 200 million dollars plus the aggregate amount authorized to be allocated for all preceding calendar years in the credit period which was not allocated. The credit period is the ten-year period beginning on January 1, 2006.

If, at the close of the credit period, the aggregate amounts allocated are less than the 2 billion dollar aggregate limit, the Governor of the State of New York and the Mayor of the City of New York may jointly allocate, for any calendar year following the credit period, for

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[272] Section 1033(g)(4).

[273] The proposal does not change the present-law rules relating to certain NYLZ private activity bond financing and additional advance refunding bonds.

expenditures with respect to qualifying projects, amounts that in sum for all years following the credit period would equal such shortfall.

Under the proposal, any expenditure for a qualifying project taken into account for purposes of the credit shall be considered State and local funds for the purpose of any Federal program.

Effective Date

The proposal is effective on the date of enactment, with an exception for property subject to a written binding contract in effect on the date of enactment which is placed in service prior to the original sunset dates under present law. The extended replacement period for involuntarily converted property ends on the earlier of (1) the date of enactment or (2) the last day of the five-year period specified in the Jobs Creation and Worker Assistance Act of 2002 ("JCWAA").[274]

28. Treatment of S corporation passive investment income

Present Law

An S corporation is subject to corporate-level tax, at the highest corporate tax rate, on its excess net passive income if the corporation has (1) accumulated earnings and profits at the close of the taxable year and (2) gross receipts more than 25 percent of which are passive investment income.

Excess net passive income is the net passive income for a taxable year multiplied by a fraction, the numerator of which is the amount of passive investment income in excess of 25 percent of gross receipts and the denominator of which is the passive investment income for the year. Net passive income is defined as passive investment income reduced by the allowable deductions that are directly connected with the production of that income. Passive investment income generally means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (to the extent of gains). Passive investment income generally does not include interest on accounts receivable, gross receipts that are derived directly from the active and regular conduct of a lending or finance business, gross receipts from certain liquidations, or gain or loss from any section 1256 contract (or related property) of an options or commodities dealer.

In addition, an S corporation election is terminated whenever the S corporation has accumulated earnings and profits at the close of each of three consecutive taxable years and has gross receipts for each of those years more than 25 percent of which are passive investment income.

[274] Pub. Law No. 107-147, sec. 301 (2002).

Description of Proposal

The proposal increases the 25-percent threshold to 60 percent and eliminates the rule terminating an S election by reason of having passive investment income for three consecutive taxable years.

Effective Date

The proposal applies to taxable years beginning after December 31, 2005.

29. Revaluation of LIFO inventories of large integrated oil companies

Present Law

A taxpayer is generally permitted to use a last-in, first-out (LIFO) method to inventory goods, on the condition that the taxpayer also uses the LIFO method in reporting to shareholders, partners, other proprietors, and beneficiaries, and for credit purposes.[275] Under the LIFO method, a taxpayer (i) treats goods on hand at the close of the taxable year as being: first, those goods included in the opening inventory of the taxable year (in the order of acquisition) to the extent thereof; and second, those acquired in the taxable year; (ii) inventories the goods at cost; and (iii) treats those goods included in the opening inventory of the taxable year in which the LIFO method was first used as having been acquired at the same time, and determines their cost by the average cost method.[276]

In periods during which a taxpayer produces or purchases more goods than the taxpayer sells (an inventory increment), a LIFO method taxpayer generally records the inventory cost of such excess (and separately tracks such amount as the "LIFO layer" for such period), adds it to the cost of inventory at the start of the period, and carries such total inventory cost forward to the beginning inventory of the following year.

In periods during which the taxpayer sells more goods than the taxpayer produces or purchases (an inventory decrement), a LIFO method taxpayer generally determines the cost of goods sold of the amount of the decrement by treating such sales as occurring out of the most recent LIFO layer (or the most recent LIFO layers, if the amount of the decrement exceeds the amount of inventory in the most recent LIFO layer) in reverse chronological order.

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[275] Sec. 472(c).

[276] Sec. 472.

Description of Proposal

The proposal disallows a portion of the benefit of the LIFO method to integrated oil companies[277] with gross receipts in excess of $1 billion for the relevant taxable year.

Specifically, the proposal requires such taxpayers to revalue each historic LIFO layer of crude oil inventories by adding to each layer an amount equal to 75 percent of the increase in the price of crude oil between the end of the most recent taxable year of the taxpayer ending in 2005, and the date which is twelve months prior to the end of such taxable year, multiplied by the number of barrels of crude oil represented by such LIFO layer; the taxpayer must reduce its cost of sales for such taxable year by a like amount.

For example, suppose a taxpayer, which is an integrated oil company with revenues in excess of $1 billion, has a 2005 starting inventory of 200 barrels, comprised of a 1955 LIFO layer with 50 barrels valued at $5 per barrel (with a total cost of $250); a 1985 LIFO layer with 100 barrels valued at $18 per barrel (with a total cost $1800); a 2000 LIFO layer with 30 barrels valued at $25 per barrel (with a total cost of $750), and a 2004 LIFO layer with 20 barrels valued at $35 per barrel (with a total cost $700), for a total inventory value of $3500. Suppose further that the price of oil over the relevant period has risen $26.67 per barrel (e.g., from $34 per barrel to $60.67 per barrel). Suppose further that the taxpayer's ending inventory is 200 barrels, i.e., the same as the starting inventory, so the taxpayer has neither an inventory increment nor an inventory decrement for the taxable year.

Under the proposal, the taxpayer will revalue each LIFO layer upwards by $20/barrel (i.e., 75% of $26.67). Thus, the taxpayer will increase its 1955 LIFO layer by $1000; its 1985 LIFO layer by $2000; its 2000 LIFO layer by $600; and its 2004 LIFO layer by $400. The taxpayer will offset this $4000 increase in inventory by reducing by $4000 the taxpayer's costs of goods sold for the most recent taxable year ending in 2005.

Effective Date

The proposal is effective for the most recent taxable year of relevant taxpayers ending in 2005.

30. Capital expenditure limitation for qualified small issue bonds

Present Law

Qualified small-issue bonds are tax-exempt State and local government bonds used to finance private business manufacturing facilities (including certain directly related and ancillary facilities) or the acquisition of land and equipment by certain farmers. In both instances, these bonds are subject to limits on the amount of financing that may be provided, both for a single

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[277] The proposal defines an "integrated oil company" by cross-reference to section 291(b)(4), which generally includes retailers and large refiners of oil or natural gas or any product derived from oil or natural gas.

borrowing and in the aggregate. In general, no more than $1 million of small-issue bond financing may be outstanding at any time for property of a business (including related parties) located in the same municipality or county. Generally, this $1 million limit may be increased to $10 million if all other capital expenditures of the business in the same municipality or county are counted toward the limit over a six-year period that begins three years before the issue date of the bonds and ends three years after such date. Outstanding aggregate borrowing is limited to $40 million per borrower (including related parties) regardless of where the property is located.

For bonds issued after September 30, 2009, the Code permits up to $10 million of capital expenditures to be disregarded, in effect increasing from $10 million to $20 million the maximum allowable amount of total capital expenditures by an eligible business in the same municipality or county.[278] However, no more than $10 million of bond financing may be outstanding at any time for property of an eligible business (including related parties) located in the same municipality or county. Other limits (e.g., the $40 million per borrower limit) also continue to apply.

Description of Proposal

The proposal accelerates the application of the $20 million capital expenditure limitation from bonds issued after September 30, 2009, to bonds issued after December 31, 2006.

Effective Date

The proposal is effective on the date of enactment for bonds issued after December 31, 2006.

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[278] Sec. 144(a)(4)(G) as added by sec. 340(a) of the American Jobs Creation Act of 2004, Pub. L. No. 108-357 (2004).