

## Analysis of H.R. 4297, Tax Relief Extension Reconciliation Act of 2005 (formerly S. 2020)

In November 2005, the Senate passed tax reconciliation legislation (S. 2020) that includes a number of charitable incentive and reform provisions. The House-passed companion bill (H.R. 4297), however, does not contain any charitable provisions. In February 2006, both chambers adopted a motion to go to a tax reconciliation conference to reconcile the differences between the two bills. Since the U.S. Constitution states that all tax bills must originate in the House of Representatives, the Senate amended and adopted the House version of the bill before adopting the motion to go to conference. Thus, the final bill that comes out of the tax reconciliation conference will have the House number, H.R. 4297.

The following is an analysis of significant provisions in the new H.R. 4297 that affect foundations:

### General Provisions

- **IRA Charitable Rollover.** Permits tax-free distributions from IRAs directly to charitable organizations or split-interest entities after the taxpayer has reached age 70 ½ years. On February 2, 2006, the bill was amended to allow split-interest gifts beginning at age 59½. This provision is only effective for two years.
- **Non-itemizer Deduction.** Donors who do not itemize deductions on their income taxes may deduct total **cash** contributions over \$210 for single filers and over \$420 for joint filers. The bill would also impose the same deduction floor (\$210/\$420) even for taxpayers that do itemize deductions. An amendment passed on February 2, 2006 clarified that the deduction floor for non-itemizers and itemizers would be effective for two years.
- **Conservation.** Language included encouraging contributions of real property made for conservation purposes.
- **State-Federal Disclosure.** Provides authority for the Internal Revenue Service to disclose information to state officials relating to exempt organizations.

### Donor-Advised Funds

- **Definition of Donor Advised Fund.** Any separately identified fund where the donor or any person appointed by the donor has or reasonably expects to have advisory privileges over either distributions or investments. The definition specifically excludes scholarship funds where the donor offers advice only as a member or a committee, where the donor doesn't control the committee, and requirements similar to those in section 4945 (concerning grants to individuals by private foundations) are followed. In addition, Treasury has authority to grant additional exclusions for funds advised by a committee that will benefit a single organization, government entity or identified charitable purpose.
- **Aggregate payout.** Imposes a 5% aggregate payout requirement for donor-advised funds. Reasonable and necessary administrative expenses, as well as most distributions to the charity hosting the donor advised fund, count towards the distribution requirement. As a transition rule, for existing funds the requirement will phase in with 3% for the first year, 4% for the second and 5% for the third year after the bill is enacted.

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- **Minimum Activity Rule.** Each donor advised fund held by an organization must make minimum distributions over a rolling consecutive three-year period equal to the greater of \$250 or 2.5% of the minimum gift (or minimum balance) required to create the fund.
- **Special rules for gifts of “illiquid assets” to fund a donor-advised fund.** The legislation creates special distribution rules when more than 10% of the assets in a donor-advised fund are “illiquid”. “Illiquid assets” includes any asset other than cash or marketable securities. Each such fund is required to make qualifying distributions equal to 5% of the total assets in the fund. In calculating the distributable amount, the value of an illiquid asset is the value of the deduction claimed by the donor plus an assumed annual rate of inflation equal to 5%. Treasury is authorized to allow adjustments if the asset has significantly declined in value. At most, the community foundation will have just over 3.5 years to begin making distributions. As a distribution transition rule, existing funds will phase in the requirement with 3% for the first year, 4% for the second and 5% for the third year after the bill is enacted.
- **Prohibition on income, estate and gift tax deductions for gifts to donor-advised funds to certain supporting organizations.** With rare exception, gifts to donor advised funds will continue to be fully deductible from gift, estate and income tax. The rare exception is that contributions to donor-advised funds maintained at Type III supporting organizations that are “operated in connection with” one or more charities will not be deductible.
- **Substantial increase in the number of disqualified persons for purposes of section 4958.** The legislation will make all donors to advised funds, all advisors to such funds, all of a charity’s investment managers, members of their families, and businesses that they control disqualified persons with respect to the charity. This will greatly enlarge the community foundation’s pool of disqualified persons by including large numbers of individuals who lack any ability to substantially influence the organization’s decisions.
- **Grants from donor-advised funds to supporting organizations.** With rare exception, donor-advised funds will be permitted to make distributions to supporting organizations. The rare exception is that distributions will not be permitted from donor-advised funds to Type III supporting organizations that are “operated in connection with” one or more charities.
- **Grants from donor-advised funds to civic organizations and to foreign charitable organizations.** Grants to civic organizations, such as the Elks or the Chamber of Commerce are prohibited even if the grant will be used for charitable purposes. Grants to foreign organizations are prohibited unless the sponsoring charity is able to determine that the recipient is the equivalent of a US public charity.

#### Supporting Organizations

- **Grants from Type III supporting organizations to donor-advised funds.** This bill continues to preclude Type III supporting organizations from making distributions to donor advised funds.
- **Excess business holdings type.** Rules similar to the private foundation excess business holding rules will apply to Type III supporting organizations.
- **5% Payout for Type III’s.** All Type III supporting organizations will be required to make qualifying distributions equal to approximately 5% of their investment assets. Reasonable and necessary administrative expenses will count as qualifying distributions.

**Private Foundations**

- **Grants from a private foundation to any supporting organization** are prohibited. The bill modifies section 4942 to clarify that such payments are not qualifying distributions. The bill also makes any payment from a private foundation to an organization described in section 509(a)(3) a taxable expenditure. Exercising expenditure responsibility does not correct the situation.
- **Increased penalties.** Penalties for all private foundation rules violations, including self-dealing, failure to distribute income, jeopardizing investments and taxable expenditures are all doubled. Further, if a self-dealing violation includes payment of compensation to disqualified persons, the penalty increases to 25%, rather than simply doubling to 10%. Such compensation violations may be abated back to 10% under certain circumstances.