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NOT FOR PROFIT GROUP

The Not for Profit Group at Murtha Cullina is pleased to provide clients and friends with information about topics of interest to tax exempt not for profits and their donors.

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TAX DEVELOPMENTS IN THE EXEMPT ORGANIZATION AREA

To paraphrase an author much better known than your editor, this is the "best of times and the worst of times" for charities.

We have all seen statistics confirming that the general public, foundations and corporations were indeed very generous with their charitable contributions during 2005. Statistics for 2006 indicate a significant increase over 2005 (one unfortunate exception is that corporate support of the arts has declined precipitously). A recent article stated that many charities benefited greatly at year-end 2006 from the new provision permitting transfers of funds from IRAs directly to public charities at no tax cost to the donors. As you know, this benefit expires at the end of 2007; with strong backing, steps are underway to extend the benefit indefinitely. The fate of this effort is uncertain, as Congress, concerned over lost tax revenue, is reviewing many provisions in the Code which reduce taxable income.

A bill has been introduced, called the "Artist-Museum Partnership Act," which would allow a deduction equal to fair market value for certain charitable contributions of literary, musical, or artistic compositions created by the donor (at the present time such a donor can deduct only his/her tax basis which impedes the contribution of art to museums).

On the other hand, there have been some highly unfortunate developments in the charitable area. For example, the Internal Revenue Service ("IRS") recently included the following in its "Dirty Dozen Tax Scams":

> "The use of tax exempt organizations to improperly shield income or assets from taxation. This can occur when a taxpayer moves assets or income to a tax-exempt supporting organization or a donor-advised fund, but retains control over the assets or income. Contributions of non-cash assets continues to be an area of abuse, especially with regard to overvaluation of contributed property."

In a talk at the Washington Tax Conference held in April of 2007, Steven T. Miller, Commissioner, Tax Exempt and Government Entities, IRS, made some interesting comments:

The charitable sector is changing rapidly, due to the following factors (among others):

- The rise of the Internet.
- The increasing concentration of wealth, and the great forthcoming transfer of wealth to the next generation.

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- The rise of the large non-profit corporation which he termed the "nation-wide non-profits that are global in scope and scale."
- The increasingly blurred line between the tax-exempt and the commercial sectors.
- The presence of abuse in the charitable sector.

To address that alleged abuse, the IRS's compliance program has three main pillars:

1. Customer education and outreach;
2. The IRS's determination program (i.e., filing for exemption by way of Forms 1023 and 1024, which he termed "upfront compliance work");
3. Examinations — between 2005 and 2006 there was a 43% increase in examination of non-profit entities, and a similar increase in IRS "contacts with such organizations."

Many in Congress believe that the tax exemption of charities and the charitable contribution deduction are abused.

The IRS also desires to promote standards of good governance, management and accountability. To promote good governance, Mr. Miller wonders whether it may best be encouraged not by IRS examinations (threatened or actual), but by "the twin tonics of full spectrum sunshine-enhanced transparency, combined with an engaged, informed and independent board of directors accountable to the community which it serves." He feels that "sunshine and good governance will drive good behavior."

Reacting to alleged "tax scams," the partially misnamed Pension Protection Act of 2006 contained a number of provisions adversely affecting certain charitable vehicles taxpayers utilize to structure charitable contributions.

For example:

(i) **Related Use Rule.** To enforce the "related use rule" (which requires that gifts of appreciated long-term capital gain personal property, as a condition of fair market value deductibility, be taken by the public charity recipient for a use related to its public purpose) the Act requires the donee charity to file a report with the IRS within **three years** (previously two years) reporting in detail on the disposition of the donated property and imposes additional taxes on the donor and the donee if it appears that there was no serious intent to satisfy the "related use rule." Especially significant penalties attach to intentional breaches of this rule. A major breach persists in the charity benefit auction area.

(ii) **Installment Donations of Personal Property to Museums.** Congress is concerned that donors were contributing art works to museums in installments, and claiming a tax deduction, while maintaining total possession of the object donated. As a result, new provisions concerning the donation of appreciated personal property in installments to museums will almost completely eliminate such transactions by significantly penalizing donors if they do not complete the donation of their retained interests in the property within ten years of the first gift, or date of death, whichever is earlier, and generally exposing donors to potentially taxable gift or estate tax transfers with regard to the portion of the retained interest that was not fully donated within the specified period. Another rule (with potential exceptions) bars deductions unless the donee charity and the donor own all interests in the object. When properly structured, these transactions

can be very helpful to the donor taxpayers and to the recipients. Fortunately, it appears that the House Ways and Means Committee will revisit this onerous provision and perhaps rescind it retroactively. In the meantime, there are frequent reports on the ever-accelerating auction prices paid for modern art — well beyond the resources of all but a few museums. (An exception is the Walton's new Crystal Bridges Museum in Arkansas, which is controversially purchasing very desirable paintings being deaccessioned by museums and other non-profit owners.) The public press frequently features articles on deaccessioning, which leads uninitiated spectators to believe that most gifts of art to charities are made with the **assumption** that they will be sold, sooner or later.

The rules concerning the taxation of supporting organizations and donor advised funds have been significantly revised.

(iii) **Donor Advised Funds (DAF).** The tax laws concerning DAF, and deductibility of contributions thereto, have been considerably tightened; the organization supported and/or the donor may be penalized if the donated properties are employed in any manner to benefit the donor, or his/her associates, except incidentally. Eliminated from the new definition of DAF are funds that distribute to only one entity; **and** those where decisions made (considering the **advice** of the donor) by a committee appointed by the sponsoring organization, not controlled by the donor, with regard to grants awarded on an objective and non-discriminatory basis to individuals for travel, study, and the like, pursuant to a procedure approved in advance by the IRS. These complex provisions deserve careful study. Congress ordered the IRS to further review these funds and report as to improper use, while a Ways and Means Committee spokesman suggests that the new provisions themselves may be overly restrictive. One proposal is that DAF be required each year to distribute a specified amount to appropriate charities. Others (e.g., the New York State Bar Association) recommended that DAF be treated more like private foundations.

(iv) **Supporting Organizations.** The attention of Congress was attracted to such entities (which generally are considered public charities) by claims of inadequate charitable distributions, loans to donors, conflict of interest transactions with donors, inappropriate investments and lack of oversight by the supported entity. New provisions establish significant penalties for "self-dealing" and the like, and inhibit private foundations from making distributions to supporting organizations which are not directly controlled by the supported entity or its trustees, or by a combination of trustees of both parties, but are so called "functionally integrated" (i.e., have a close working relationship with the supported entity, and make key distributions to it each year). As a result, some supporting organizations are restructuring themselves. In some cases a supporting organization will be recast as a private foundation if it accepts contributions from parties who control the supporting organization or its supported parent. Again Congress has ordered the IRS to review and report on such entities. As with DAF, one proposal is that supporting organizations be required to make annual distributions to the entity(ies) they support.

(v) **Qualified Appraiser Definition.** The definition of "qualified" appraiser required for non-cash or non-public security gifts of over $5,000 has been significantly (many say unreasonably) tightened.

All of the above accentuates the point made often in earlier editions of this bulletin — **each taxpayer has the responsibility of respecting the charitable sector and the IRC provisions granting charitable contribution deductions.** To do otherwise may lead to further restrictive legislation.

2006 Report of IRS Art Advisory Panel. Each year, a panel of art valuation experts meets to review art appraisals supporting charitable deductions of art valued at $20,000 or more. In 2006, the panel reviewed 124 charitable deduction cases with a claimed value of $219,000,000. The panel recommended adjustments amounting to a 57% percent reduction in the value claimed for 61% of the items reviewed. In the case of estate art, the panel recommended a 95% increase in the claimed valuations for those items adjusted. The recommendations of the panel become the position of the IRS, and many cases are settled on that basis.

Compensation. Fueled by a report indicating significant failures to report compensation accurately, the IRS is more closely monitoring the compensation paid to principal executives of 501(c)(3) entities. Over half the charities reviewed failed to obtain the rebuttable presumption of reasonable compensation by satisfying the three pronged test of (i) use of an independent body to set compensation, (ii) salary comparables, and (iii) recordkeeping. The 2006 Act increased penalties across the board for transgressions such as excess benefit transactions (intermediate sanctions).

ELSEWHERE IN THE CHARITBLE AREA

Charitable Remainder Trusts and Unrelated Business Taxable Income. Before 2007 if a charitable remainder trust had **an iota of unrelated business taxable income**, it forfeited its tax-exempt organization status for that year. Obviously, this could have dire tax consequences to the trust. Commencing with taxable years beginning after December 31, 2006, a CRUT's unrelated business taxable income does not disqualify the trust from tax exemption, **but, as a penalty, the unrelated business taxable income is taxed at a 100% rate**. Exceptions to unrelated business taxable income are: interest, dividends, rent (if the landlord does not provide extensive services), and the sale of certain assets. If the donor to a CRUT should transfer a business to the CRUT, much of the income generated by that business could be unrelated.

Reporting of Tax Basis. A bipartisan Treasury staff proposal is circulating which would require financial institutions to report to the IRS the seller's tax basis for securities sold. Not surprisingly, the financial service industry opposes this proposal — which, however, if enacted might make the donation of appreciated securities to charity even more advantageous.

Charitable Gift Annuity Rates. On April 2, 2007, the Board of the American Council on Gift Annuities voted to make no change to its current schedule of recommended gift annuity rates. Visit http://www.acga-web.org for details.

General Information

The editor has recently published a paper in the "Tax Exempt Law Review" titled "Reflections on Deductibility of Contributions of Items of Tangible Personal Property to Museums." On October 24, 2007 a conference will be held at the University of Hartford on "Tax and Art Law." One participant will be Karen Carolan, the Chair of the IRS Art Advisory Panel. The *Journal of Gift Planning* published an interesting article titled "Involving the Board in the Fun of Charitable Giving." If a reader is interested in any of the above, please contact Jim Lyon.

This newsletter is one of a series of publications by Murtha Cullina LLP and should not be construed as legal advice or legal opinion on any specific facts or circumstances. The contents are intended for general information purposes only, and you are urged to consult your own lawyer concerning your own situation and any specific legal questions you may have.

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