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THE PENSION PROTECTION ACT OF 2006: A MISGUIDED ATTACK ON DONOR-ADVISED FUNDS AND SUPPORTING ORGANIZATIONS

by

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I. INTRODUCTION

In 2006, with the passage of the Pension Protection Act (PPA),[1] Congress provided the tools for the Internal Revenue Service (IRS) to launch a full-scale attack on tax-exempt, charitable organizations, particularly sponsoring organizations of donor-advised funds, donor-advised funds, and supporting organizations, as well as their donors and advisors. In fact, the IRS already had every tool it needed to monitor, regulate, and sanction donor-advised funds and supporting organizations. The legislation was primarily enacted as a message to the IRS to go after donor-advised funds and supporting organizations. As an incentive, Congress passed Draconian penalty excise taxes that apply only to donor-advised funds and supporting organizations, and not to other public charitable organizations. The impact of this legislation has been to dissuade donors from creating donor-advised funds and, as a result, to negatively impact the ability of public charities to provide the types of assistance and support that communities across the United States have relied on for decades.

The PPA's amendments impacting sponsoring organizations, donor-advised funds, and supporting organizations has added incomprehensible complexity to the Code that flies directly in the face of recommendations from the Treasury Department. Moreover, these amendments open the door to the types of IRS abuses discussed in this article. Tragically, the economic costs to these charitable organizations will result in less revenue being expended for vital community needs.

This article will (1) introduce the PPA's amendments that have negatively impacted donor-advised funds and supporting organizations, (2) explain the events that led up to the misguided enactment of these amendments, particularly with regard to intermediate sanctions and the "incidental benefit" provisions, (3) analyze the impact that these amendments have had and will have on exempt organizations, including donors, officers, employees, and advisors to donor-advised funds and supporting organizations, and (4) explain why Congress' and the IRS's attack on donor-advised funds and supporting organizations is both bad tax and public policy.

II. BACKGROUND

Charitable organizations described in IRC section 501(c)(3) are classified under IRC section 509 as either public charities or private foundations, depending on their exempt purposes, the sources of their financial support, or their manner of operation.[2] A contribution to a public charity allows a taxpayer

1. Pension Protection Act of 2006 (Pub. L. 109-280).
2. See generally IRS Notice 2007-21.

to take a higher charitable deduction than a contribution to a private foundation.[3] Supporting organizations are classified as IRC section 501(c)(3) charitable organizations.[4] Donor-advised funds often are established and maintained by public charities through sponsoring organizations that are also classified as IRC section 501(c)(3) charitable organizations.[5]

A 501(c)(3) or (4) organization is not operated exclusively to further a tax-exempt purpose if its net earnings inure to the benefit of a private shareholder or individual.[6] In addition, such an organization is not organized and operated exclusively to further an exempt purpose if it is operated for the benefit of private interests.[7] The private inurement rule addresses the issue of benefits to an organization's insiders. The private benefit rule prohibits an exempt organization from providing benefits (other than incidental benefits) to any person, whether or not that person is an insider. (Of course, benefits may be provided to the class of persons that fall within the scope of the organization's exempt purpose).

A. Supporting Organizations

In general, supporting organizations are tax-exempt organizations that provide support to another 501(c)(3) organization that is not a private foundation. To qualify as a supporting organization, an organization must: (1) be organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of, one or more "publicly supported organizations;"[8] or (2) be operated, supervised, or controlled by, or in connection with, one or more publicly supported organizations;[9] and (3) not be controlled directly or indirectly by one or more disqualified persons (as defined in 4946) other than foundation managers and one or more publicly supported organizations.[10]

By qualifying as a supporting organization under 509(a)(3), a nonexempt charitable organization can avoid being classified as a "private foundation," which is subject to much stricter regulation. Supporting organizations are public charities that fulfill their exempt purposes by supporting one or more other exempt organizations. The primary feature of a supporting

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3. Id.

4. Supporting organizations that meet the requirements of 501(c)(3) are classified as public charities. See IRC § 509(a)(3).

5. See generally IRS Notice 2007-21.

6. IRC § 501(c)(3); Treas. Reg. § 1.501(c)(3)-1(d)(2)(ii).

7. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii).

8. IRC § 509(a)(3)(A).

9. IRC § 509(a)(3)(B).

10. IRC § 509(a)(3)(C).

organization is its very close bonds to the organization(s) it supports. The Code recognizes three different types of supporting organizations.[11]

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11. The Code provides that certain supporting organizations (generally, organizations that support another 501(c)(3) organization that is not a private foundation) are classified as public charities rather than private foundations. IRC § 509(a)(3). To qualify as a supporting organization, the organization must meet all of the following tests:

(1) it must be organized and at all times operated exclusively for the benefit of, or to perform the functions of, or to carry on the purposes of, one or more "publicly supported organizations" (as described in IRC § 509(a)(1) or (2)) (the "organizational and operational tests"). IRC § 509(a)(3)(A);

(2) it must be operated, supervised, or controlled by, or in connection with, one or more publicly supported organizations (the "relationship test"). IRC § 509(a)(3)(B); and

(3) it must not be controlled directly or indirectly by one or more disqualified persons other than foundation managers and other than one or more publicly supported organizations (the "lack of outside control test"). IRC § 509(a)(3)(C).

The Joint Committee on Taxation, Technical Explanation of H.R. 4 (Aug. 3, 2006) explained:

> 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 a "Type I" supporting organization); (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).
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> See Treas. Reg. § 1.509(a)-4(f)(2).
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> In the case of a "Type I" supporting organization, one or more supported organizations must exercise a substantial degree of direction over the policies, programs, and activities of the supporting organization. Treas. Reg. § 1.509(a)-4(g)(1)(i). The relationship between the Type I supporting organization and the supported organization is comparable to that of a parent and subsidiary. This type of relationship may be established by the fact that a majority of the directors, officers or trustees of the supporting organization are appointed or elected by the governing body, officers, or the membership of one or more supported organizations. Id.
>
> "Type II" supporting organizations are supervised or controlled in connection with one or more publicly supported organizations. Instead of a parent-subsidiary relationship, the relationship between a Type II supporting organization and its supported organization is more like a brother-sister relationship. To satisfy the relationship requirement, generally there must be a

common supervision or control by the persons supervising or controlling both the supporting organization and the publicly supported organizations. Treas. Reg. § 1.509(a)-4(h)(1). An organization is usually 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 the payments is enforceable under state law. Treas. Reg. § 1.509(a)-4(h)(2).

"Type III" supporting organizations are "operated in connection with" one or more publicly supported organizations. To satisfy the "operate din connection with" test, Treasury regulations require that the supporting organization be responsive to, and significantly involved in the operations of, the publicly supported organization. This relationship is considered to exist where the supporting organization meets two tests: (1) the "responsiveness test," and (2) the "integral part test." Treas. Reg. § 1.509(a)-4(i)(1). In general, the responsiveness teat requires Type III supporting organizations be responsive to the needs and demands or the publicly supported organization. The integral part test requires a Type III supporting organization to maintain significant involvement in the operations of one or more publicly supported organizations, and that the publicly supported organizations also dependent upon the supporting organization for the type of support that it provides.

The Treasury regulations provide two alternative methods for satisfying the integral part test:

(1) establish that 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, the supported organizations; and establish that these activities, *but for* the involvement of the supporting organization, normally would be engaged in by the publicly supported organizations themselves. Treas. Reg. § 1.509(a)-4(i)(3)(ii) (emphasis added). Organizations that satisfy this "but for" test are referred to as "functionally integrated" Type III supporting organizations.

(2) establish that the supporting organization pays substantially all of its income to, or for the use of, one or more publicly supported organizations; establish that the amount of support received by one or more of the publicly supported organizations is sufficient to insure the attentiveness of the organization(s) to the operations of the supporting organization (known as the "attentiveness requirement"); and establish that a significant amount of the total support of the supporting organization goes to those publicly supported organizations that meet the attentiveness requirement. Treas. Reg. § 1.509(a)-4(i)(3)(iii).

The IRS has defined the term "substantially all" of a supporting organization's

B. Sponsoring Organizations and Donor-Advised Funds

Some charitable organizations (sponsoring organizations/sponsoring charities) establish one or more donor-advised funds to which donors may contribute and provide nonbinding advice with regard to distributions in the funds or investment decisions of the fund. These sponsoring organizations, however, must have both control and legal ownership of the assets following the donor's contribution for that contribution to qualify for the charitable deduction.[12] Similarly, if the sponsoring organization permits the donor to have too much control over the amounts contributed, the donation may not qualify for the charitable deduction.[13]

Donors often contribute to donor-advised funds because they can give a large contribution in a single year, receive a full charitable deduction at that time, and not have the contribution distributed for charitable purposes until later years. Donor-advised funds usually require donations of at least $100,000, but some accept smaller donations. In addition, donors often have their name attached to the fund, much like a private foundation. A contribution to a donor-advised fund is deductible as an outright gift to charity. The maximum itemized deduction for cash contributions (50% of the taxpayer's adjusted gross income) is allowed if the contribution is to an entity such as a church; publicly supported charitable, religious, educational, scientific, or literary organization; private operating foundation; or IRC section 509(a)(3) supporting organization (with some limitations).[14] Special rules apply to the gifting of capital gain property.[15]

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income to mean 85% or more. Rev. Rul. 76-208, 1976-1 C.B. 161. Joint Committee on Taxation, Technical Explanation of H.R. 4.

Congress and the IRS have been particularly concerned about the opportunity for abuses with Type III supporting organizations because their relationship to the publicly supported organization is the most tenuous among the three types of supporting organizations. This is the reason that a Type III supporting organization must meet both the responsiveness and integral part test. See generally CCH's Tax Exempt Advisor No. 379, Practitioners Discuss IRS Focus on Exempt Organizations, Provide Solutions (Feb. 13, 2006).

12. See generally Joint Committee on Taxation, supra note 11.

13. Id.

14. IRC § 170(b)(1)(A).

15. Generally, gifts of securities and real estate held longer than one year are deductible at their full present fair market value, with no tax on appreciation. IRC § 170(e). Gifts of long-term capital gain property are deductible up to 30% of adjusted gross income with a five-year carry-over for the excess. IRC § 170(b)(1)(C)(i). Special provisions apply so that donors may elect to raise the ceiling. See generally IRC § 170(b)(1)(c)(3), (e)(1)(B).

III. INTERMEDIATE SANCTIONS PRIOR TO THE 2006 AMENDMENTS

A. Enactment

The Taxpayer Bill of Rights of 1996 added section 4958 to the IRC.[16] IRC section 4958 applies to acts of self-dealing between tax-exempt organizations and disqualified persons. It is patterned after IRC section 4941, which applies to acts of self-dealing between private foundations and disqualified persons. IRC section 4958 applies to organizations that are exempt from federal income taxes under IRC sections 501(c)(3) and 501(c)(4).[17]

The Committee on Ways and Means submitted a House Report on the 1996 Taxpayer Bill of Rights that discussed the provisions of IRC section 4958.[18] The Committee explained that prior to the Taxpayer Bill of Rights, there was no provision for the "imposition of penalty excise taxes in cases where a 501(c)(3) public charity or a 501(c)(4) social welfare organization engages in a transaction that results in private inurement."[19] The only provision with penalty excise taxes was related to private foundations and was codified in IRC section 4941.[20] As a result, the only sanction that could be imposed against a public charity was revocation of the organization's tax-exempt status.[21] The Committee indicated that the reasons for enacting intermediate sanction provisions were "to ensure that the advantages of tax-exempt status ultimately benefit the community and not private individuals."[22] It noted that the legislation would provide for intermediate sanctions to be imposed when nonprofit organizations engaged in transactions with insiders that would result in private inurement.[23]

Section 4958 imposes penalty excise taxes, known as intermediate sanctions, in cases in which organizations that are exempt under sections 501(c)(3) and 501(c)(4) engage in excess benefit transactions with a disqualified person.[24] An "excess benefit transaction" subject to tax under IRC section 4958 is:

> (1) any transaction in which an economic benefit is provided by a section 501(c)(3) organization (except for a private foundation) or a section 501(c)(4) organization directly or

16. Pub. Law No. 104-168, § 1311(a), 110 Stat. 1452, 1475 (1996).
17. IRC § 4958(c).
18. H.R. Rep. No. 104-506, at 1 (1996), *reprinted in* 1996 U.S.C.C.A.N. 1143, 1143.
19. Id. at 54.
20. Id.
21. Id.
22. Id. at 55.
23. Id.
24. IRC § 4958(a).

indirectly to, or for the use of, any disqualified person if the value of the economic benefit exceeds the value of the consideration (including the performance of services) received for providing the benefit;[25] or

(2) any transaction, to the extent provided in the Treasury Regulations, in which the amount of any economic benefit to, or for the use of, any disqualified person is based on the exempt organization's income in a transaction that violates the private inurement prohibition under IRC sections 501(c)(3) and 501(c)(4).[26]

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25. IRC § 4958(c)(1); Treas. Reg. § 53.4958-1(b). See also IRS Notice 96-46, 1996-2 C.B. 212 (Sept. 23, 1996).

26 H.R. Rep. No. 104-506 (1996). The private inurement prohibition on charities goes back to the Tariff Act of 1909. Tariff Act of 1909, ch. 6 § 38, 36 Stat. 112. In 1919 the statute was amended to specify that a charitable organization's "net earnings" could not inure to the benefit of any private shareholder or individual. The Taxpayer Bill of Rights 2 of 1996 (Public Law 104-168) extended the private inurement prohibition to 501(c)(3) organizations to 501(c)(4) organizations. Essentially, the private inurement prohibition provides that an organization is eligible for tax-exempt status *only* if no part of its net earnings inures to the benefit of any private shareholder or individual. H.R. Rep. No. 104-506 (1996). Treas. Reg. § 53.4948-4(a)(1) discusses excess benefit transactions. It provides that "the rules of this section apply to all transactions with disqualified persons, regardless of whether the amount of the benefit provided is determined, in whole or in part, by the revenues of one or more activities of the organization."

Generally, private inurement refers to benefits to insiders, such as officers and directors, through the use or distribution of the organization's funds. See Treas. Reg. § 1.501(c)(3)-1(c)(2). The IRS has focused on four primary issues in enforcing the prohibition against private inurement: (1) that the organization does not pay more than "reasonable compensation" for services rendered (Treas. Reg. § 1.162-7(b)(3)); (2) that the organization does not pay excessive rent for the use of property; (3) that the organization does make loans that do not conform to the prevailing interest rate or do not meet normal criteria for security or other guarantees (See., e.g., Orange County Agric. Soc'y v. Comm'r, 893 F.2d 529 (2d Cir. 1990) (interest free loans to organization insiders constitutes private inurement); and (4) whether a donor retains an interest in a donated asset.

The case of Ginsberg v. Commissioner, 46 T.C. 47 (1966), is considered the benchmark case addressing public versus private benefit (inurement). In that case, an exempt organization was formed to dredge a navigable waterway that fronted its members' private properties. The waterway was rarely used by the public and the dredging appreciated the value of the members' properties. Evidence was submitted that the organization's members contributed funds to the organization in accordance with the value of the member's property. The court held that the organization's purpose was substantially a nonexempt purpose and that the public benefit was incidental. But see, IRS Rev. Rul. 70-186, 1970-1 C.B. 128 (exempt organization that improved a lake

A "disqualified person" is any person who was, at any time during the five-year period ending on the date of the excess benefit transaction, in a position to exercise substantial influence over the affairs of the organization.[27] Disqualified persons also include family members and certain entities in which at least 35% of the control or beneficial interests are held by a disqualified person.[28]

As enacted in 1996, IRC section 4958 imposed three taxes (intermediate sanctions):

(1) A "first-tier" penalty excise tax equal to 10% of the excess benefit amount is paid by any organization manager[29] who knowingly participates in an excess benefit transaction;[30]
(2) A "first-tier" penalty excise tax equal to 25% of the excess benefit amount is paid by any disqualified person who engages in an excess benefit transaction;[31] and
(3) A "second-tier" penalty excise tax equal to 200% of the excess benefit amount is paid by any disqualified person if the excess benefit transaction is not corrected within the taxable period.[32]

There is no "second-tier" penalty imposed on organization managers. In 1997, IRC section 4962(b) was amended and cross-referenced to IRC section 4958. The practical effect of this amendment was to make it clear that the IRS had the authority to abate the first-tier excise taxes if it was established that the excess benefit transaction was due to reasonable cause and not willful neglect *and* the transaction was corrected within the specified time period.

The IRS has the discretion to impose intermediate sanctions instead of, or in addition to, revocation of an organization's tax-exempt status.

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extensively used by the public for public recreational purposes was primarily a public benefit even though the adjoining landowners (who were primarily but not solely contributors to the exempt organization) also received a benefit; the benefit was held to be incidental to the general public's primary benefit).

27. IRC § 4958(f)(1)(A).

28. IRC § 4958(f)(1)(B), (C).

29. An organization manager is an "officer, director, trustee, or any individual having powers and responsibilities similar to those of an officer, director, or trustee. IRC § 4958(f)(2). See also IRS Notice 96-46, 1996-2 C.B. 212 (Sept. 23, 1996).

30. IRC § 4958 (a)(2). With respect to this third tax, any one excess benefit transaction could not result in an amount exceeding $10,000. The 2006 amendments raised this amount to $20,000.

31. IRC § 4958 (a)(1).

32. IRC § 4958 (b).

B. IRS Enforcement of IRC Section 4958 Prior to the 2006 Amendments

> When IRC section 4958 was first passed, it was touted as applying only to major transgressions and not to "foot faults." Since then it has morphed into a generally applicable rule used not only for conflict of interest violations but also for paperwork and judgment infractions.[33]

After IRC section 4958's intermediate sanctions provisions were enacted, the IRS needed to implement a plan to enforce these penalty excise tax provisions. From 1996 through 2002, the IRS released a series of memoranda regarding IRC section 4958, which basically stated and restated that it was unable to provide real guidance on intermediate sanctions.

In October 1996, the IRS initiated a temporary procedure for handling all cases involving intermediate sanctions or IRC section 501(c)(4) inurement.[34] Instead of providing guidance to the IRS Field Offices, the memorandum noted that there were no regulations covering these issues, even though the statutory changes made under IRC section 4958 were retroactive to September 14, 1995.[35] The IRS noted that without regulations, Field Offices were "unable to assert positions with respect to issues arising under the new provisions, either during examinations of exempt organizations, or in subsequent negotiations with taxpayers to close examinations."[36] In an attempt to ensure some level of national uniformity in the resolution of these cases, the IRS directed the Field Offices to contact the Assistant Chief, Project Branch 1, before asserting any position with respect to intermediate sanctions and private inurement and exempt organizations.[37] Nearly two years later, the IRS released a memorandum restating the October 1996 memorandum and noting that proposed regulations under IRC section 4958 had still not been issued.[38]

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33. Excise Tax on Excess Benefit Transactions: Introduction (CCH-EXP, Federal-Exempt ¶ 4994E.01 (quoting Barnaby Zall, Weinberg & Jacobs, LLP, Rockville, Md.).

34. IRS Mem. (Oct. 30, 1996).

35. Id.

36. Id.

37. Id. The Assistant Chief would then inform the IRS agent what information should be included in the request. Id.

38. The IRS noted in IRS Mem. (Jun. 25, 1998) that the issuance of regulations was a "priority item for 1998." However, in the meantime IRS Field Offices were instructed to continue contacting the Assistant Chief with all questions concerning intermediate sanctions. All examinations in which IRC § 4958 was an issue were required to be submitted for technical advice, including all cases in which a tax under IRC § 4958 was proposed, as well as any cases considered for a closing agreement in which an IRC § 4958 excess benefit transaction or inurement issue was an issue to be

On August 24, 1998, the IRS released proposed regulations under IRC section 4958 that failed to provide any real guidance to IRS Field Offices.[39] The proposed regulations made it clear that the IRS could seek intermediate sanctions and the revocation of an organization's tax-exempt status.[40] Four months later, the IRS acknowledged "widespread interest within the exempt organization community regarding excess benefit audits."[41] The IRS made public three internal memoranda requiring field staff to coordinate with the IRS National Office examinations that might involve intermediate sanctions, private inurement, and qualification of exempt status.[42] On April 13, 1999, the IRS again released a memorandum restating that field staff must contact the IRS National Office about any examinations that might involve intermediate sanctions, private inurement, and qualification of exempt status.[43]

C. Final Regulations under IRC Section 4958

In 2001, the Treasury Department and the IRS issued temporary regulations under IRC section 4958. The preamble to the temporary regulations

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resolved in the closing agreement. It was also stated that separate technical advice was necessary for persons with interests inconsistent with the exempt organization or the interests of other persons that participated in the excess benefit transaction. Id.

39. IRS Notice of Proposed Rulemaking, REG-246256-96. The proposed regulations stated that "[t]he excise taxes imposed by § 4958 do not affect the substantive statutory standards for tax exemption under § 501(c)(3) or (4)." The preamble to the 1998 proposed regulations stated that the IRS will "exercise its administrative discretion in enforcing the requirements of §§ 4958, 501(c)(3), and 501(c)(4). Four factors were listed that the IRS would consider in "determining whether an applicable tax-exempt organization described in § 501(c)(3) continues to be described in § 501(c)(3) in cases in which § 4958 excise taxes are also imposed: (1) whether the organization has been involved in repeated excess benefit transactions; (2) the size and scope of the excess benefit transactions; (3) whether, after concluding that it has been a party to an excess benefit transaction, the organization has implemented safeguards to prevent future recurrences; and (4) whether there was compliance with other applicable laws. 63 Fed. Reg. 41,488-489.

40. Id.

41. IRS Exempt Orgs. Mem. (Dec. 23, 1998).

42. Id.

43. IRS Announcement of Release of Exempt Orgs. Mem. (Apr. 13, 1999). Three days later the IRS released another memorandum restating that separate technical advice was necessary for persons with interests inconsistent with the exempt organization, or the interests of other persons that participated in the excess benefit transaction. Exempt Orgs. Mem. (Apr. 16, 1999).

stated that the IRS intended to publish guidance regarding the factors it will consider "as it *gains more experience* in administering section 4958."[44] The final regulations relating to excise taxes on excess benefit transactions under IRC section 4958 became effective on January 23, 2002.[45] The regulations focus on

44. IRS Notice of Proposed Rulemaking (REG-111257-05), 70 FR53599-01, 2005-2 C.B. 759 (Sept. 9, 2005) (emphasis added).

45. T.D. 8978, 2002-1 C.B. 500 (corrected Mar. 19, 2002). The 2002 IRC § 4958 final regulations included the following provisions:

Treas. Reg. § 53.4958-1(e)(1) provides that except as otherwise provided, an excess benefit transaction occurs on the date on which the disqualified person receives the economic benefit for federal income tax purposes. Treas. Reg. § 53.4958-1(e)(2) provides that in the case of rights to future compensation, including benefits under a nonqualified deferred compensation plan, the excess benefit transaction occurs on the date the right to future compensation is not subject to a substantial risk of forfeiture. However, where a disqualified person elects under § 83(b) of the Code to include deferred compensation in gross income in a taxable year, any excess benefit transaction with respect to this deferred compensation occurs in that year.

Treas. Reg. § 53.4958-1(f)(1) provides that § 4958 of the Code applies to transactions occurring on or after September 14, 1995. However, under Treas. Reg. § 53.4958-1(f)(2), § 4958 does not apply to any transaction occurring pursuant to a written contract that was binding on September 13, 1995, and at all times thereafter before the transaction occurs. But if a binding written contract is materially changed, it is treated as a new contract entered into as of the date the material change is effective. The regulations state: "A material change includes an extension or renewal of the contract ..., or a more than incidental change to any payment under the contract." The extension or renewal of a contract that results from the contracting person unilaterally exercising an option expressly granted by the contract is not a material change.

Treas. Reg. § 53.4958-3(a)(1) defines a disqualified person, with respect to any transaction, as any person who was in a position to exercise substantial influence over the affairs of an applicable tax-exempt organization at any time during the five-year period ending on the date of the transaction.

Treas. Reg. § 53.4958-3(b)(1) provides that a person is a disqualified person with respect to any transaction with an applicable tax-exempt organization if the person is a member of the family of a person who is a disqualified person with respect to any transaction with the same organization. A person's family includes the person's spouse.

Treas. Reg. § 53.4958-3(c) provides that voting members of the governing body, presidents, chief executive officers, or chief operating officers are persons who are in a position to exercise substantial influence over the affairs of the organization.

Treas. Reg. § 53.4958-4(a)(1) of the regulations provides that to determine whether an excess benefit transaction has occurred, all consideration and benefits exchanged between a disqualified person and the applicable tax-exempt organization and all entities it controls are taken into account.

Treas. Reg. § 53.4958-4(a)(3)(ii)(A) provides that the term "fixed payment" means an amount of cash or other property specified in the contract, or determined by a fixed formula specified in the contract, which is to be paid or transferred in exchange for the provision of specified services or property. A fixed formula may incorporate an excise taxes imposed on excess benefit transactions and disqualified persons included: (1) contemporaneous substantiation requirements regarding benefits to a disqualified person as compensation for services; (2) an explanation of what constitutes disregarded economic benefits in situations where benefits were provided on equal terms to a disqualified person as well as to other donors; (3) a definition of "knowing" participation of an organization manager in an excess benefit transaction; and (4) requirements for organizations receiving correction

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amount that depends upon future specified events or contingencies, provided that no person exercises discretion when calculating the amount of a payment or deciding whether to make a payment (such as a bonus). Treas. Reg. § 53.4958-4(a)(3)(v) provides that if the parties make a material change to a contract, it is treated as a new contract as of the date the material change is effective.

Treas. Reg. § 53.4958-4(b)(1)(ii)(A) that the value of services is the amount that would ordinarily be paid for like services by like enterprises under like circumstances (i.e., reasonable compensation). The standards under § 162 of the Code apply in determining the reasonableness of compensation, taking into account the aggregate benefits provided to a person and the rate at which any deferred compensation accrues. Treas. Reg. § 53.4958-4(b)(1)(ii)(B) provides that the compensation for purposes of determining reasonableness under § 4958 includes all economic benefits provided by the organization in exchange for the performance of services, except for economic benefits that are disregarded for purposes of 4958 under Treas. Reg. § 53.4958-4(a)(4).

Treas. Reg. § 53.4958-4(b)(2) provides that the facts and circumstances to be taken into consideration in determining the reasonableness of a fixed payment are those existing on the date the parties enter into the contract pursuant to which the payment is made.

Treas. Reg. § 53.4958-6(a) provides that payments under a compensation arrangement are presumed to be reasonable if all of the requirements in Treas. Reg. § 53.4958-6(c) are satisfied, as follows:

1. The compensation arrangement is approved in advance by an authorized body of the organization or an entity it controls, composed entirely of individuals who do not have a conflict of interest as to the compensation arrangement or property transfer;

2. Prior to making its determination, the authorized body obtained and relied upon appropriate data as to comparability; and

3. The authorized body adequately documented the basis for its determination concurrently with making that determination.

Treas. Reg. § 53.4958-6(e) provides that the fact that a transaction between an organization and a disqualified person is not subject to the rebuttable presumption of reasonableness does not create any inference that the transaction is an excess benefit transaction. See Priv. Ltr. Rul. 200244028 (Jun. 21, 2002). Note that these final regulations remain virtually unchanged, except for technical corrections, but do not reflect the 2006 amendments to IRC § 4958.

amounts due to excess benefit transaction involving a property transfer by an exempt organization to a disqualified person.[46]

The final regulations provided specific rules for determining the fair market value of economic benefits under IRC section 4958. In addition, the final regulations allowed exempt organizations a rebuttable presumption that a transaction was not an excess benefit transaction.[47]

The final regulations also contained numerous examples covering when a person was a disqualified person (although these examples did not include when an excess transaction would occur).[48] Examples illustrating when economic benefits were provided indirectly did focus on excess benefits.[49] The

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46. Id.

47. Treas. Reg. § 53.4958-6 provides that payments under a compensation arrangement are presumed to be reasonable and a transfer of property is presumed to be at fair market value if three conditions are met:

(1) the compensation arrangement or terms of the property transfer are approved in advance by an authorized body or committee of the organization composed entirely of individuals who do not have a conflict of interest with respect to the proposed transactions;
(2) the authorized body obtained and relied upon appropriate data as to comparability prior to making the determination; and
(3) the authorized body adequately documented the basis for its determination concurrently with making the determination.

If all of these conditions were met, the IRS could only rebut the presumption if it developed sufficient contrary evidence to rebut the probative value of the comparability data that the authorized body relied on. Treas. Reg. § 53.4958-6(b).

48. Id.

49. Treas. Reg. § 53.4958-4(a)(2)(iv) provides the following four examples:

Example 1. K is an applicable tax-exempt organization for purposes of § 4958. L is a wholly-owned taxable subsidiary of K. J is employed by K, and is a disqualified person with respect to K. K pays J an annual salary of $12m, and reports that amount as compensation during calendar year 2001. Although J only performed services for K for nine months of 2001, J performed equivalent services for L during the remaining three months of 2001. Taking into account all of the economic benefits K provided to J, and all of the services J performed for K and L, $12m does not exceed the fair market value of the services J performed for K and L during 2001. Therefore, under these facts, K does not provide an excess benefit to J directly or indirectly.

Example 2. F is an applicable tax-exempt organization for purposes of § 4958. D is an entity controlled by F within the meaning of paragraph (a)(2)(ii)(B) of this section. T is the chief executive officer (CEO) of F. As CEO, T is responsible for overseeing the activities of F. T's duties as CEO make him a disqualified person with respect to F. T's compensation package with F represents the maximum reasonable compensation for T's services as CEO. Thus, any additional economic benefits that F provides to T without T providing additional consideration constitute an excess benefit. D contracts with T to provide enumerated consulting services to D. However, the contract does not require T to perform any additional services for D that T is not already examples, however, primarily addressed the issue of compensation. Similarly, examples illustrating the rules governing fixed payments made pursuant to an initial contract focused primarily on compensation and the initial contract exception.[50] Other examples illustrated the timing of determining the reasonableness of compensation or a fixed payment[51] and the contemporaneous substantiation requirement.[52] The final examples addressed the data necessary to create a rebuttable presumption of reasonableness (again, these examples focused on compensation)[53] and the requirements for correction.[54]

The examples in the final regulations created an impression that the IRS was primarily interested in situations where a disqualified person received

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obligated to perform as F's chief executive officer. Therefore, any payment to T pursuant to the consulting contract with D represents an indirect excess benefit that F provides through a controlled entity, even if F, D, or T treats the additional payment to T as compensation.

Example 3. P is an applicable tax-exempt organization for purposes of section 4958. S is a taxable entity controlled by P within the meaning of paragraph (a)(2)(ii)(B) of this section. V is the chief executive officer of S, for which S pays V $w in salary and benefits. V also serves as a voting member of P's governing body. Consequently, V is a disqualified person with respect to P. P provides V with $*x* representing compensation for the services V provides P as a member of its governing body. Although $x represents reasonable compensation for the services V provides directly to P as a member of its governing body, the total compensation of $w + $x exceeds reasonable compensation for the services V provides to P and S collectively. Therefore, the portion of total compensation that exceeds reasonable compensation is an excess benefit provided to V.

Example 4. G is an applicable tax-exempt organization for § 4958 purposes. F is a disqualified person who was last employed by G in a position of substantial influence three years ago. H is an entity engaged in scientific research and is unrelated to either F or G. G makes a grant to H to fund a research position. H subsequently advertises for qualified candidates for the research position. F is among several highly qualified candidates who apply for the research position. H hires F. There was no evidence of an oral or written agreement or understanding with G that H will use G's grant to provide economic benefits to or for the use of F. Although G provided economic benefits to H, and in connection with the receipt of such benefits, H will provide economic benefits to or for the use of F, H acted with a significant business purpose or exempt purpose of its own. Under these facts, G did not provide an economic benefit to F indirectly through the use of an intermediary.

50. Treas. Reg. § 53.4958-4(a)(3)(vi). Treas. Reg. § 53.4958-4(a)(3)(i) provides that "§ 4958 does not apply to any fixed payment made to a person pursuant to an initial contract," unless the "person fails to perform substantially the person's obligations under the initial contract during that year." Treas. Reg. § 53.4958-4(a)(3)(iv).

51. Treas. Reg. § 53.4958-4(b)(2)(iii).

52. Treas. Reg. § 53.4958-4(c)(4).

53. Treas. Reg. § 53.4958-6(a)(3)(iv).

54. Treas. Reg. § 53.4958-7(f).

excessive compensation or payments above the fair market value for services or other consideration provided to the exempt organization. These regulations left many issues unanswered, but they did not seem overly biased in favor of the IRS because of the rebuttable presumption regulations that created a quasi-safe harbor for exempt organizations.

D. New Final Regulations

The Treasury Department and the IRS issued new final regulations clarifying the requirements for tax exemption under IRC section 501(c)(3) and how these requirements relate to the imposition of excise taxes on excess benefit transactions under IRC section 4958.[55] The final regulations primarily reaffirmed that a private benefit may involve noneconomic as well as economic benefits, be inconsistent with exempt status if the benefit is substantial instead of merely incidental to the exempt organization's purpose, and be a private benefit even if the transaction is at fair market value.[56] The examples make it clear that the IRS considers itself to have an independent basis to revoke an exempt organizations status even if the private benefit does not involve an economic benefit or raise the issue of the fair market value of a transaction.[57]

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55. T.D. 9390, I.R.B. 855 (Mar. 27, 2008) (corrected Apr. 28, 2008).

56. Id.

57. Id. *Example 3*. (i) O conducts educational programs for the benefit of the general public. Since its formation, O has employed its founder, C, as its Chief Executive Officer. Beginning in Year 5 of O's operations and continuing to the present, C caused O to divert significant portions of O's funds to pay C's personal expenses. The diversions by C significantly reduced the funds available to conduct O's ongoing educational programs. The board of trustees never authorized C to cause O to pay C's personal expenses from O's funds. Certain members of the board were aware that O was paying C's personal expenses. However, the board did not terminate C's employment and did not take any action to seek repayment from C or to prevent C from continuing to divert O's funds to pay C's personal expenses. C claimed that O's payments of C's personal expenses represented loans from O to C. However, no contemporaneous loan documentation exists, and C never made any payments of principal or interest.

(ii) The diversions of O's funds to pay C's personal expenses constitute excess benefit transactions between an applicable tax-exempt organization and a disqualified person under § 4958. Therefore, these transactions are subject to the applicable excise taxes provided in that section. In addition, these transactions violate the proscription against inurement under § 501(c)(3) and ¶ (c)(2) of this section.

(iii) The application of the factors in paragraph (f)(2)(ii) of this section to these facts is as follows. O has engaged in regular and ongoing activities that further exempt purposes both before and after the excess benefit transactions occurred. However, the size and scope of the excess benefit transactions engaged in by O beginning in Year 5, collectively, are significant in relation to the size and scope of O's activities that further exempt purposes. Moreover, O has been involved in multiple excess benefit

The new final regulations stress that an exempt organization that implements safeguards that are reasonably calculated to prevent excess benefit transactions will have those safeguards treated as a factor in favor of its continuing to receive exempt status. This will be the case even if the organization implements these safeguards in direct response to an excess benefit transaction, such as contesting the existence of an excess benefit transaction at issue, or as a general governance policy.[58]

Two commentators had suggested that the final regulations clarify the relationship between the determination of an organization's exempt status and the determination of the existence of an excess benefit transaction. The suggestion that the IRS not take action to remove an organization's exempt status on excess benefit transaction grounds while the IRS's determination of the existence of an excess benefit transaction was being contested in court was rejected. In their response, the Treasury Department and the IRS stated that "the determination of an organization's exempt status and the determination of the existence of an excess benefit transaction are separate determinations, involving distinct parties, different legal elements, and separate processes, even though they may relate to the same facts."[59]

This author is troubled by the fact that the IRS has both weapons to use simultaneously against an exempt organization. It is conceivable that an exempt organization will be bullied into paying excess benefit transaction penalty taxes, even if the organization has a solid case that no excess benefit transactions took place, in order to keep its exempt status.

E. Donor-Advised Funds

At the American Bar Association (ABA) Section of Taxation's 1999 mid-year meeting (January 15, 1999), "government officials overseeing tax-exempt organizations" told the ABA that donor-advised funds had come under scrutiny in 1998, "when officials became aware of charitable arrangements that seemed to blur the line between public charities and private foundations."[60]

The preamble to the Temporary Regulations noted that the IRS and Treasury Department considered adopting a special rule with respect to donor-

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transactions. O has not implemented any safeguards that are reasonably calculated to prevent future diversions. The excess benefit transactions have not been corrected, nor has O made good faith efforts to seek correction from C, the disqualified person who benefited from the excess benefit transactions. Based on the application of the factors to these facts, O is no longer described in § 501(c)(3) effective in Year 5. Treas. Reg. § 1.501(c)(3)-1(f)(2)(iv).

58. T.D. 9390, I.R.B. 855 (Mar. 27, 2008) (corrected Apr. 28, 2008).

59. Id.

60. Government Officials Warn of 1999 Scrutiny for Donor-Advised Funds, Insurance Schemes, The Bureau of National Affairs, No. 11 (Jan. 19, 1999).

advised funds, and sought comments on potential issues raised by applying the fair market value standard under IRC section 4958 to distributions from donor-advised funds to (or for the use of) a donor or advisor.[61] Several comments were received on this issue and "[m]ost of the comments objected to treating a donor or advisor to this type of fund as a disqualified person based solely on influence over a donor-advised fund."[62] Other commentators stated that "the existing factors contained in the temporary regulations were adequate to find disqualified person status in appropriate circumstances."[63]

The IRS and the Treasury Department stated that in response to these comments, "the final regulations do not adopt a special rule regarding any donor or advisor to a donor-advised fund. Thus, the general rules of section 53.4958-3 will apply to determine if a donor or advisor is a disqualified person."[64]

IV. THE IRS'S STEPPED-UP ENFORCEMENT OF IRC SECTION 4958

A. IRS Confusion

The IRS's enforcement of IRC section 4958 prior to 2004 does not appear to have been particularly aggressive. This is true in part because the IRS was unable to develop guidance for taxpayers or IRS field representatives and, in part, because field representatives were required to submit all issues that might involve intermediate sanctions, private inurement, and qualification of exempt status to the IRS National Office.[65]

The IRS's private rulings from 1997 through 2004 do not indicate an aggressive stance in enforcing IRC section 4958. In fact, the bulk of these IRC section 4958 rulings focused on whether an individual was a disqualified person and the traditional question of whether the organization's transactions resulted in private inurement to a disqualified person.[66] Generally, when the IRS found that an excess benefit transaction had or had not occurred, it reached an obvious conclusion. For example, an annual monetary award presented by a public charity was not an excess benefit transaction because disqualified persons were excluded from eligibility.[67] A person who was the most senior officer of an exempt organization who was responsible for the day-to-day operations, served on the board, and had substantial influence over the organization was a

61. T.D. 8978, 2002-1 C.B. 500.
62. Id.
63. Id.
64. Id.
65. See supra notes 31-33 and accompanying text.
66. See supra notes 4, 5 and accompanying text.
67. Priv. Ltr. Rul. 98-02-045 (Oct. 16, 1997).

disqualified person under IRC section 4958.[68] A taxpayer who was a disqualified person and organization manager received excess benefits from salary, severance, undocumented loans, automobile valuations, property rents, and insurance payments.[69]

In a series of private letter rulings, the IRS found that the excess benefit transaction proscriptions were violated in situations involving churches and disqualified individuals, usually when the situations were particularly egregious.[70]

B. The IRS Gets Aggressive: Stepped-up Enforcement and the Carracci Case

In late July 2004, the IRS began its Tax Exempt Compensation Enforcement Project. This Project was designed to identify excess benefit transactions in terms of excessive compensation and benefits to exempt organization officers and "other insiders."[71] The IRS announced that it was contacting nearly 2,000 charities and foundations in an effort to identify and halt abuses by exempt organizations.[72] The Project's focus included the compensation of "specific officers and various kinds of insider transactions, such as loans and the sale, exchange or leasing of property to officers and others."[73] In addition, the IRS also focused on how exempt organizations answered

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68. Priv. Ltr. Rul. 2002-44-028 (Jun. 21, 2002). The IRS cited the applicable 2002 regulations in great detail in making its determinations. See supra notes 39-49 and accompanying text.

69. T.A.M. 200243057 (Jul. 2, 2002).

70. See e.g., IRS Priv. Ltr. Rul. 2004-35-018 (May 5, 2004), IRS Priv. Ltr. Rul. 2004-35-019 (May 5, 2004), IRS Priv. Ltr. Rul. 2004-35-020 (May 5, 2004), IRS Priv. Ltr. Rul. 2004-35-021 (May 5, 2004), IRS Priv. Ltr. Rul. 2004-35-022 (May 5, 2004) (the founder of a church and his wife, son and son-in-law engaged in excess benefit transactions by (1) using the church truck for private business, (2) use of church credit cards for private purchases, (3) gasoline purchases, (4) private use of cell phone paid for by church, (5) unsubstantiated expenses paid by the church to the son, (6) expenses for the founder's personal residence, including a security system, landscaping, satellite television, telephone service and unsubstantiated expenses, (7) meals, and (8) use of church provided computer. But see IRS Priv. Ltr. Rul. 2004-21-010 (Feb. 24, 2004) (shared use of office space, employees and office equipment did not result in excess benefit transaction).

71. IRS News Release IR-2004-106 (Aug. 10, 2004).

72. Id. IRS Commissioner Mark W. Everson stated that "the IRS has an obligation to investigate questionable compensation practices and put a stop to the abuses we find. We won't let the misbehavior of a few organizations damage the credibility of the vast majority of law-abiding charities and foundations." Id.

73. Id.

questions on their Form 990 "about excess benefit transactions – and other compensation information."[74]

It appeared that the IRS was taking a reasonable position in enforcing IRC section 4958 and attempting to learn more about exempt organizations, their practices, and the degree to which excess benefit transactions were a serious issue. While the IRS's public proclamations regarding excess benefit transactions seemed reasonable, the IRS adopted an aggressive enforcement approach that was shocking in its unreasonableness.

The first major case that interpreted IRC section 4958 was *Caracci v. Commissioner*.[75] The Court of Appeals for the 5th Circuit ruled that the Tax Court had erred as a matter of law when it affirmed the IRS's determination that excess benefit transaction excise taxes were warranted on a group of home health agencies. The agencies had transferred assets resulting from conversion of the exempt organization to a nonexempt organization. The Court of Appeals held further that the Tax Court erred in its valuation of the assets and liabilities transferred and made clearly erroneous findings of fact when applying the valuation method. From the record, it was obvious that the plaintiff-appellants did not receive an excess benefit from the transfer and were not liable for the excise taxes.

In *Caracci*, the IRS had issued deficiency notices requiring the taxpayers, three privately held home healthcare agencies and the family that owned and operated them, to pay over $250 million in excise taxes under IRC section 4958.[76] The IRS based this amount on its internal valuation of the assets and liabilities transferred when the agencies converted to nonexempt status. The IRS found that the taxpayers received a net excess benefit of $18.5 million.[77] During the two-year audit and almost two years of litigation, the IRS maintained that the deficiency notices and underlying valuations were correct.[78] At trial before the Tax Court, the IRS finally conceded that the deficiency notices were "excessive and erroneous."[79] The Tax Court also recognized that the IRS's deficiency notices were wrong and that the IRS's valuation expert – whose data was the only evidential support that the IRS presented for imposing excise taxes – also had made significant errors in analysis.[80] Even so, the Tax Court affirmed the IRS's decision to impose excise taxes, finding that the fair market value of the assets transferred to the nonexempt organizations exceeded the value of the liabilities and debts assumed by over $5 million.[81]

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74. Id.
75. 456 F.3d 444 (5th Cir. 2006), *rev'g* 118 T.C. 379.
76. Id. at 447.
77. Id.
78. Id.
79. Id.
80. Id.
81. Id.

The IRS's position on appeal was that the deficiency notices were erroneous and the Tax Court had made a $1.78-million error in its valuation analysis.[82] But the IRS insisted that the Tax Court was correct in finding that the taxpayers received an excess net benefit of over $5 million in the conversion to nonexempt status and thus owed $69,702,390 in excise taxes under IRC section 4958(a) and (b).[83]

In the first paragraph of its analysis of the case, the appellate court stated that "there are so many legal and factual errors – many of which the Commissioner acknowledges – infecting this case from the outset that reversal must result."[84] For purposes of this article, what is most telling are the tactics the IRS employed and its motivation for employing these tactics in order to impose excess benefit excise taxes against the taxpayers. Among the tactics and motivations:

(1) The issued deficiency notices were based on a "brief, intermediate internal analysis, which "stated on its face that it was intermediate and that a final economic study had to be performed."[85]
(2) The IRS ignored the disclaimer that a final economic study had to be performed and issued the deficiency based notices asserting excise tax penalties and retroactively revoking the exempt status of the organizations.[86]
(3) Internal IRS documents revealed that the IRS issued the notices on the basis of the intermediate internal analysis rather than a final economic study because the IRS wanted to prevent the taxpayers from correcting these "prohibited transactions" and, thereby, reduce the amount of the intermediate sanction penalties.[87]
(4) "Even more disturbing," said the appellate court, was that the trial record revealed that despite the "tentative and incomplete nature of the analysis used as the basis for the deficiency notices, the [IRS] Commissioner defended the correctness of those notices for several years into this litigation" and finally conceded that the notices overstated the IRS's tax claim when the trial began before the Tax Court.[88]

82. Id.
83. Id.
84. Id. at 456.
85. Id. at 457.
86. Id.
87. Id.
88. Id.

(5) The IRS also relied on the intermediate internal analysis because it was worried about the statute of limitations, which the IRS blamed on the taxpayers.[89]

In its strongest condemnation of the IRS's tactics, the appellate court stated:

> This court has recognized that when, as here, the Commissioner persists in taking a position in litigation that is so incongruous as to call his motivation into question, …[i]t can only be seen as one aimed at achieving maximum revenue at any cost, …seeking to gain leverage against the taxpayer in the hope of garnering a split-the-difference settlement – or, failing that, then a compromise judgment – somewhere between the value returned by the taxpayer…and the unsupported excess value eventually proposed by the Commissioner.[90]

The appellate court reversed the Tax Court's decision instead of remanding the case because it found clearly from the record that the IRS could not meet its burden of proof in this matter.[91]

V. THE PENSION PROTECTION ACT OF 2006 TARGETS DONOR-ADVISED FUNDS AND SUPPORTING ORGANIZATIONS

On August 17, 2006, President Bush signed the PPA. The PPA made significant changes to the Code, impacting donor-advised funds (and the sponsoring organizations set up to hold the funds) and supporting organizations. While the changes to the intermediate sanctions provisions in IRC section 4958 were the most oppressive of these changes, the PPA also added IRC section 4967, which imposes an excise tax on donors, advisors, or related persons (but not investment advisors) who advise a sponsoring organization to make a distribution from a donor-advised fund that results in that person receiving, directly or indirectly, *more than an incidental benefit*. In addition, the PPA added IRC section 4966, which imposes a 20% tax on a sponsoring organization for taxable distributions and a five-percent tax on any fund manager who knowingly makes such a distribution (with a limit of a $10,000 tax imposed on management).

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89. Id. An IRS employee stated in an affidavit that the IRS asked the taxpayers to extend the limitations period and informed the taxpayers that without their agreement to extend the limitations period, the IRS would proceed based on the best information it had at that point.

90. Id. at 457 (*citing Dunn*, 301 F.3d at 339, 349 (5th Cir. 2002), *rev'g* and *rem'g* 79 TCM 1337, CCH Dec. 53,713 (M)).

91. Id. at 462.

The IRS may not impose penalties under both IRC sections 4958 and 4967. No additional taxes will be imposed on any distribution if a tax has already been imposed with respect to the distribution under the excess benefit rules of IRC section 4958.

A. PPA's Amendments to the Intermediate Sanctions Provisions

The PPA made three significant changes to IRC section 4958 (intermediate sanctions):

(1) For transactions after July 25, 2006, the definition of "excess benefit" and "excess benefit transaction" was broadened as those terms relate to IRC section 509(a)(3) supporting organizations. For transactions after August 17, 2006, the definition of a "disqualified person" was expanded.[92]

(2) For transactions after August 17, 2006, the definition of "disqualified person" for the purpose of excess benefit transaction taxes was extended to include donors, donor advisors, and

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92. A "disqualified person" (in regards to a supporting organization) is any person who (1) was in a position to exercise substantial influence over the affairs of the organization at any time during the five-year period preceding the transaction in question, (2) was a member of the family of such an individual, or (3) was a 35% controlled entity. IRC § 4958(f)(i)(I).

An "excess benefit transaction (in regards to supporting organizations) includes any grant, loan, compensation or similar payment made by a supporting organization to a substantial contributor, family member of a substantial contributor or a 35% controlled entity." IRC § 4958(c)(3)(A). Any loan that a supporting organization makes to a disqualified person (excluding organizations described in IRC § 509(a)(1), (2), and (4)) also is an excess benefit transaction. Id.

An "excess benefit" is the amount of the grants, loans or similar payments. IRC § 4958 (c)(3)(A).

A "substantial contributor" is a person who contributed or bequeathed in excess of $5,000 to the supporting organization if the aggregate contributions constitute in excess of two percent of the total contributions and bequests received by the supporting organization in the tax year in which the funds were received. If the contributions are from a trust, the contributions from the trust and the creator of the trust are aggregated. Organizations described in IRC § 509(a)(1), (2), and (4) are not considered substantial contributors under this provision. IRC § 4958(c)(3)(C).

A 35% entity is (1) a corporation in which a substantial contributor to a supporting organization or a family member (as defined in IRC § 4958(f)(4)) if such an individual owns more than 35% of the total combined voting power; (2) a partnership in which such a person owns more than 35% of the profits and interests; or (3) a trust or estate in which such persons own more than 35% of the beneficial interest. IRC § 4958(c)(3)(B).

investment advisors to donor-advised funds (and family members). These persons are *automatically* treated as disqualified persons with respect to the excess benefit transaction rules of IRC section 4958.[93]

(3) For transactions after August 17, 2006, the dollar limitation on the penalty of managers of public charities and social welfare organizations who participate in excess benefit transactions was doubled from $10,000 to $20,000.[94]

Although the term "donor-advised fund" has been commonly used for years, it was not until the PPA that it was finally defined. A "donor-advised fund" is a fund or account:

(1) that is separately identified by reference to contributions of a donor or donors;
(2) that is owned and controlled by a sponsoring organization; and
(3) with respect to which a donor (or any person appointed or designated by the donor (a "donor advisor") has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of the amounts held in the fund or account by reason of the donor's status as a donor.[95]

A "sponsoring organization" is an organization that:

(1) is described in IRC section 170(c) (describing organizations to which charitable contributions can be made) and without regard to

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93. An "investment advisor" in terms of any supporting organization is any person (other than an employee of the sponsoring organization) that is compensated by the sponsoring organization for managing the investment of, or providing investment advice with respect to, assets maintained in the donor-advised funds owned by the sponsoring organization. IRC § 4958(f)(8).

Distributions from a donor-advised fund to a person who, with respect to that fund, is a donor, donor advisor, or a related person (though not an investment advisor) *automatically* will be treated as an excess benefit transaction under IRC § 4958, with the entire amount paid to the disqualified person being deemed the amount of the excess benefit. IRC § 4958(c)(2).

Any amount repaid as a result of correcting an excess benefit transaction will not be held in or credited to any donor-advised fund. IRC § 4958(f)(6).

94. IRC § 4958(d)(2).

95. IRC § 4966(d)(2). All three prongs of the definition must be met for a fund or account to be treated as a donor-advised fund. Joint Committee on Taxation, supra note 11.

any requirement that the organization be organized in the United States;[96]
(2) is not a private foundation under IRC section 509(a); and
(3) maintains one or more donor-advised funds.[97]

B. PPA's Provision Imposing Excise Taxes on More than Incidental Benefits

The PPA added IRC section 4967, which imposes two excises taxes impacting sponsoring organizations and its donors, donor advisors, and related persons. The taxes imposed are:

(1) 125% of the amount of the benefit on the person who *advised* the distribution and received a benefit as a result of the distribution;[98] and
(2) 10% of the benefit on the agreement of any *fund manager* to make a distribution, knowing that the distribution would confer an improper benefit, unless the agreement is not willful and is due to reasonable cause. The tax imposed on fund managers is limited to $10,000.[99]

C. PPA's Provision Imposing Taxes on Sponsoring Organizations for Taxable Distributions and Distributions to Certain Supporting Organizations

The PPA added IRC section 4966, which imposes a 20% tax on a sponsoring organization for taxable distributions to any natural person or to any other person if the distribution is for any purpose other than the charitable, or other purposes specified in IRC section 170(c)(2)(B), or the sponsoring organization does not exercise expenditure responsibility as provided in IRC section 4945(h).[100] A 5% tax is imposed on the agreement of any fund manager

96. IRC § 170(c)(2)(A). A government entity described in IRC § 170(c)(1) is not, by definition, a sponsoring organization. Joint Committee on Taxation, supra note 11.

97. IRC § 4966(d)(1).

98. IRC § 4967(a)(1).

99. IRC § 4967(a)(2).

100. IRC § 4966(c). The expenditure responsibility rule generally requires "that an organization exert all reasonable efforts and establish adequate procedures" to ensure that the distributions from the organization are spent solely for purposes for which they are made, to obtain full and complete reports from the distribute on how the funds are spent, and to make full, detailed reports regarding the expenditures to the IRS. A taxable distribution does not include a distribution to: (1) an organization described in IRC § 170(b)(1)(a) (other than a disqualified supporting organization; (2) the sponsoring

to make a distribution if the fund manager knows it is a taxable distribution (limited to $10,000).[101]

In addition, grants from donor-advised funds to non-functionally integrated Type III supporting organizations are potentially taxable transactions, as well as grants to Type I, Type II, and Type III (functionally integrated) supporting organizations. This is the case only if the donor or any person designated by the donor controls a supported organization of the organization, or the IRS determines that a distribution to such organization is inappropriate.[102]

D. Differences between IRC Section 4966 and Section 4967

IRC section 4967 addresses the issue of donors and donor advisors receiving more than an incidental benefit when a sponsoring organization makes a distribution from a donor-advised fund. IRC section 4966 generally addresses any distributions from a donor-advised fund that is made for a noncharitable purpose or to a supporting organization in certain situations, even though the supporting organization meets the public charity criteria of IRC section 509(a)(3).

E. Study of Donor-Advised Funds and Supporting Organizations

In addition to these changes, the PPA of 2006 also directed the Treasury Department to undertake a study of the organization and operation of donor-advised funds and supporting organizations, and to report its findings within one year of August 17, 2006. When this article was written, the study was not yet released. The purpose of the study was to monitor the effectiveness of the new rules governing the activities of these organizations and how the issues affecting them are addressed.[103]

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organization of the donor-advised fund; or (3) to another donor-advised fund. See Joint Committee on Taxation, supra note 11.

101. IRC § 4966(b)(1).

102. IRC § 4966(d)(4).

103. Specifically, the study was designed to determine whether:

> (1) the deductions allowed for the income, gift, or estate taxes for charitable contributions to sponsoring organizations of donor-advised funds or to “supporting organizations” described in IRC § 509(a)(3) are appropriate in consideration of the use of the contributed assets or the use of the assets of such organizations;
>
> (2) donor-advised funds should be required to distribute for charitable purposes a specified amount in order to ensure that the sponsoring organization is operating

The PPA also contained many other provisions that impacted sponsoring organizations and donor-advised funds[104] and supporting organizations.[105]

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consistent with the purpose or functions constituting the basis for its exemption;

(3) the retention by donors to organizations of rights or privileges is consistent with the treatment of such transfers as completed gifts qualify for the deduction for income, gift, or estate taxes, and

(4) the three issues raised above are also issues with respect to other forms of charities or charitable donations.

Pension Protection Act of 2006 § 1226(a). It is this author's opinion that the purpose of this study was to provide a basis for enacting even more burdensome federal laws on exempt organizations, especially donor-advised funds and supporting organizations.

104. In addition to the changes that are the subject of this article, the PPA amendments to the IRC impacted donor-advised funds and sponsoring organizations in other ways:

(1) For tax years after August 17, 2006, the tax on excess business holdings that previously applied only to private foundations also apply to donor-advised funds. IRC § 4943(3).

(2) Limitations were imposed on the income tax deductibility of contributions to donor-advised funds. Contributions to sponsoring organizations for the maintenance of a donor-advised fund is not deductible if the sponsoring organization is a veteran's organization or lodge, fraternal society, or a cemetery company. Except for cemetery companies, these deductions are also denied for federal estate and gift taxes. See IRC §§ 170(f)(18), 2055(e)(5), 2522(c)(5). No deduction is allowed for contributions to a non-functionally integrated Type III supporting organization. IRC § 4943(f)(5)(B).

(3) Sponsoring organizations are required to include: (a) the total number of donor-advised funds owned by the organization; (b) the aggregate value of assets held in these funds at the end of each tax year; and (c) the aggregate contribution to and grants from the funds during the tax year. IRC § 6033(k).

(4) Donors must obtain a contemporaneous written acknowledgement from the sponsoring organization that provides that the sponsoring organization has exclusive legal control of the assets contributed. This statement is required for each contribution to a donor-advised fund. See IRC §§ 170(f)(18)(B), 2055(e)(5)(B), 2522(c)(5)(B).

105. The PPA added complex new rules that apply to supporting organizations. After August 17, 2006, Type III supporting organizations must provide each supported organization with any information that the IRS may deem necessary to verify that the supporting organization "remains responsive to the needs and demands of the supported organization." IRC § 509(f)(1)(a). In addition:

(1) Type III supporting organizations may not be operated in connection with any supported organization that is not organized in the United States. There is a transition rule that delayed the effective date of this provision for three years if the supporting organization was already operated in connection with non-U.S. supported organizations. IRC § 509(f)(1)(B)(ii).

(2) If a Type I or Type III supporting organization supports an organization that is controlled by a donor (with some exceptions), the supporting organization is treated as a private foundation instead of a public charity for purposes of the relationship test. (See supra note 11). These supporting organizations will fail the relationship test if they accept gifts or donations from: (a) any person (other than IRC § 509(a)(1), (2), or (4) organizations) who controls, directly or indirectly, either alone or together with persons listed in the next two provisions (b) and (c), the governing body of a supported organization; (b) any family member described in (a) above; or (c) a 35% controlled entity as described in IRC § 509(f)(2)(B).

(3) The Treasury Department was directed to create new regulations governing the payout requirements of non-functionally integrated Type III supporting organizations. These regulations were to require Type III supporting organizations to make significant distributions of a percentage of income or assets to supported organizations. Pension Protection Act of 2006 § 1241(d).

(4) With certain exceptions, the tax on excess business holdings was expanded to apply to Type III supporting organizations that are not functionally integrated. Type II supporting organizations are also impacted by the excess business holdings provisions if they accept gifts or donations from a person (other than a public charity, but not a supporting organization) with direct or indirect control over the governing body of an organization supported by the supporting organization, a member of the person's family, or a 35% controlled entity. IRC § 4943(f).

(5) The definition of a "qualifying distribution" was modified so that payments made by a non-operating private foundation to a supporting organization do not constitute a qualifying distribution. The definition of a "taxable expenditure" was changed to provide that any amounts that private foundations paid to supporting organizations would be treated as a taxable expenditure unless the private foundation exercises expenditure responsibility. As a result, no payments to Type III supporting organizations that are not functionally integrated count as a qualifying distribution. IRC § 4942(g)(4)(A)(i). No payments made to Type I or II supporting organizations, or to organizations that are supervised or controlled in connection with Type I or II organizations, or to functionally integrated Type III supporting

VI. JCT AND IRS GUIDANCE ON THE 2006 AMENDMENTS

The Joint Committee on Taxation (JCT) provided tax practitioners with its analysis of the PPA's amendments impacting supporting organizations, donor-advised funds, and sponsoring organizations.

A. JCT Report on Amendments to IRC Section 4958: Impact on Donor-Advised Funds

The JCT Report addressed four key changes impacting donor-advised funds: (1) automatic excess benefit transactions; (2) disqualified persons; (3) taxable distributions;[106] and (4) more than incidental benefit.[107] However, it was the JCT's example of the incidental benefit provision that drew the most attention from tax practitioners.[108]

Barely mentioned in the JCT Report was the fact that Congress, in enacting the amendments to IRC section 4958, had opted to treat donors, donor advisors, and investment advisors to donor-advised funds much more harshly than from the generally applicable rule. The generally applicable rule provides that an excess benefit is the "amount by which the value of the economic benefit provided exceeds the value of the consideration received."[109] Instead, the *entire amount* of the payment is treated as the amount of the excess benefit, even if the donor-advised fund received valuable consideration from the donor, donor advisor, or other disqualified person.[110]

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considerations, count as qualifying distributions if: (a) a disqualified person of the private foundation controls, directly or indirectly, either the organization or a supported organization; or (b) such a distribution is declared inappropriate by regulations issued by the IRS. IRC § 4945(d)(4)(A).

(6) Supporting organizations are subject to new tax return requirements that must include information concerning the organizations it supports, whether it meets the definitional requirements of IRC § 509(a)(3)(B), and a certification that it is not directly or indirectly controlled by one or more disqualified persons. IRC §§ 6033(a)(3)(B) and 6033(l).

106. A 20% tax is imposed sponsoring organizations of donor-advised funds for taxable distributions under IRC § 4966(a), and an additional tax is imposed on a fund manager who knowingly agrees to make a taxable distribution (up to a limit of $10,000).

107. See supra notes 4, 5 and accompanying text.

108. See supra note 103 and accompanying text.

109. Joint Committee on Taxation, supra note 11, n.524.

110. Id.

B. Excise Tax on More Than Incidental Benefits to Disqualified Persons

If disqualified persons[111] provide advice to a donor-advised fund that results in any disqualified person receiving more than an incidental benefit, an excise tax of 125% of the benefit is imposed on that person.[112]

Of primary concern to practitioners was the very low threshold that the JCT set in its example of an "incidental benefit" from a distribution made from a donor-advised fund. The JCT Report stated:

> In general, under the provision, there is more than an incidental benefit if, as a result of a distribution from a donor advised fund, a donor, donor advisor, or related person with respect to such fund receives a benefit that would have reduced (or eliminated) a charitable contribution deduction if the benefit was received as a part of the contribution to the sponsoring organization. If, for example, a donor advises that a distribution from the donor's donor advised fund be made to the Girl Scouts of America, and the donor's daughter is a member of the local unit of the Girl Scouts of America, the indirect benefit the donor receives as a result of such contribution is considered incidental under the provisions, as it generally would not have been reduced or eliminated the donor's deduction if it had been received as part of a contribution by the donor to the sponsoring organization.[113]

Whether the JCT example will define when an incidental benefit becomes an excess benefit remains to be seen. However, by setting such a low threshold, sponsoring organizations and donors, donor-advisors, and related persons must be very cautious. The following hypothetical examples illustrate this point:

- *Example 1:* The donor advises that the distribution from the donor-advised fund be made to a special Girl Scout fund that will pay for Girl Scouts across the country to travel to the Girl Scouts International Jamboree in Japan, and the donor's daughter is among a group of 2,000 Girl Scouts that will have their expenses paid.

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111. Disqualified persons are the persons described in IRC § 4958(f)(7).

112. IRC § 4967. If an excess benefit excise tax is assessed under IRC § 4958, then an IRC § 4967 tax is not imposed. See supra notes 97, 98 and accompanying text.

113. Joint Committee on Taxation, supra note 11, n.528 and accompanying text.

- *Example 2:* Same facts as in Example 1, but the fund is set up to pay the expenses of Girl Scouts in the local community, so that 15 girls have their expenses paid.
- *Example 3:* Same facts as in Example 2, but the fund is set up to pay the expenses of the Girl Scouts in the local community who cannot afford to travel to the Jamboree. A decision was made that either all of the 15 girls would be able to go or that none of them would go. As a result of the distribution from the donor-advised fund, the donor (Mother) and her daughter are able to go to the Jamboree at their own expense, while the donation allows other girls, who could not afford to go, to attend. But for the distribution from Mother's donor-advised fund, the donor and her daughter would not have been able to attend.
- *Example 4:* The donor (Mother) is the leader of her daughter's Girl Scout troop and also works part-time for the Girl Scouts of America, and receives $20,000 compensation for her services. She advises the donor-advised fund to make a distribution to her city's Girl Scout chapter. The distribution funds the local Girl Scout chapter, which, in part, pays her salary and also provides funds to her to use as the leader of her daughter's scout troop.

In which of these examples does an incidental benefit become an excess benefit? There are no clear guidelines. This author maintains that there will never be clear guidelines because there are so many possible variations on just this single example provided in the JCT's Report. The IRS relies on a "facts and circumstances test" to determine when excess (or more than incidental) benefits occur. Without meaning to seem glib, this author sees this rule as a "one-cookie/two-cookie rule." Taking one cookie may be only an incidental benefit whereas taking two cookies may result in an excess benefit, subjecting the taxpayer to intermediate sanctions under IRC section 4958. What happens when a taxpayer takes 1.25 or 1.5 or 1.67 cookies? Without clearer guidelines, the only possible result will be serious inconsistencies in enforcement and significant confusion for sponsoring organizations and donor-advised funds.

C. JCT Report on Amendments Impacting Supporting Organizations

As previously stated, barely mentioned in the JCT Report was that Congress, in enacting the amendments to IRC section 4958, opted to treat supporting organizations much more harshly than other exempt organizations. IRC section 4958 provides that if a supporting organization is involved in an excess benefit transaction, the *entire amount* of the payment is treated as the amount of the excess benefit. The general rule is that the amount by which the value of the economic benefit provided exceeds the value of the consideration received is the amount of the excess benefit that is subject to the penalty excise tax.[114]

D. IRS Guidance

Substantive IRS guidance for donor-advised funds and supporting organizations regarding the PPA's amendments is in the process of being developed. However, the IRS has issued two notices that have provided some technical guidance.

Notice 2006-109 explained that sponsoring organizations of donor-advised funds may determine the Type I or Type II status of a supporting organization by (1) obtaining a written statement, signed by an authorized representative of the supporting organization, that describes the relationship between the supporting organization and its supported public charities; and (2) reviewing and retaining copies of the supporting organization's current governing documents establishing the Type I or Type II relationship. For distributions to Type III supporting organizations, the IRS suggested that sponsoring organizations of donor-advised funds obtain more detailed information to substantiate the relationship required for a Type III supporting organization to meet the requirements for being "functionally integrated" (meeting the "but for" test).[115]

The primary problem confronting the IRS was the fact that sponsoring organizations (some of which managed hundreds of donor-advised funds) were being asked to play detective and draw the fine line between integrated and non-integrated Type III supporting organizations. In Notice 2006-109 the IRS stated that until the Treasury Department and IRS could issue regulations defining a "functionally integrated Type III supporting organization," a grantor may rely on the standards set forth in the Notice[116] to determine whether the grantee is a

114. Joint Committee on Taxation, supra note 11, n.569.

115. Treas. Reg. § 1.509(a)-4(l)(3)(ii).

116. IRS Notice 2006-109:

Section 3, .01, A. To establish that a grantee is a Type I or a Type II supporting organization, a grantor, acting in good faith, may rely on a written representation signed by an officer, director or trustee of the grantee that the grantee is a Type I or Type II supporting organization, provided that:

> i. the representation describes how the grantee's officers, directors, or trustees are selected, and references any provisions in governing documents that establish a Type I (operated, supervised, or controlled by) or a Type II (supervised or controlled in connection with) relationship (as applicable) between the grantee and its supported organization(s); and

ii. the grantor collects and reviews copies of governing documents of the grantee (and, if relevant, of the supported organization(s)).

B. To establish that a grantee is a functionally integrated Type III supporting organization a grantor, acting in good faith, may rely on a written representation signed by an officer, director or trustee of the grantee that the grantee is a functionally integrated Type III supporting organization, provided that:

i. the grantee's representation identifies the one or more supported organizations with which the grantee is functionally integrated;

ii. the grantor collects and reviews copies of governing documents of the grantee (and, if relevant, of the supported organization(s)), and any other documents that set forth the relationship of the grantee to its supported organizations, if such relationship is not reflected in the governing documents; and

iii. the grantor collects and reviews a written representation signed by an officer, director or trustee of each of the supported organizations with which the grantee represents that it is functionally integrated describing the activities of the grantee and confirming, consistent with § 3.02 of this notice, that but for the involvement of the grantee engaging in activities to perform the functions of, or to carry out the purposes of, the supported organization, the supported organization would normally be engaged in those activities itself.

As an alternative to relying on a written representation from a grantee and specified documents as described in A or B above, a grantor may rely on a reasoned written opinion of counsel of either the grantor or the grantee concluding that the grantee is a Type I, Type II, or functionally integrated Type III supporting organization.

A private foundation considering a grant to a Type I, Type II, or functionally integrated Type III supporting organization may need to obtain a list of the grantee's supported organizations from the grantee to determine whether any of the supported organizations is controlled by disqualified persons of the private foundation. See § 3.02, below, for the definition of control that may be used. If such control exists, the grant may not be a qualifying distribution and the foundation may be required to exercise expenditure responsibility with respect to the grant.

Similarly, a sponsoring organization considering a grant from a donor-advised fund to a Type I, Type II, or functionally integrated Type III supporting organization may need to obtain a list of the grantee's supported organizations from the grantee to determine whether any of the supported organizations is controlled by the fund's donor or donor advisor (and any related parties). See § 3.02, below, for the definition of control that may be used. If such control exists, the sponsoring organization will be required to exercise expenditure responsibility.

Section 3, .02 The Service and the Treasury Department intend to issue regulations regarding the meaning of "control" under §§ 4942(g)(4)(A) and public charity and to determine the grantee's public charity classification under IRC section 509(a)(1), (2), or (3). Perhaps recognizing this heavy burden being placed on sponsoring organizations, the IRS provided in the Notice that sponsoring organizations, "acting in good faith," may rely on information from the IRS Business Master File (BMF) or the grantee's current IRS letter recognizing the grantee's tax-exempt status. In every situation, the sponsoring organization is required to verify that the grantee is listed in Publication 78, Cumulative Lists of Organizations Described in Section 170(c) of the Code of 1986, or obtain a copy of the current IRS letter recognizing the grantee as exempt from federal income tax.

The IRS also provided transitional relief and filing procedures for certain charitable trusts that fail the responsiveness test for Type III supporting organizations.[117]

4966(d)(4)(A) and the definition of a "functionally integrated Type III supporting organization" under § 4943(f)(5)(B). Until those regulations are issued, a grantor may rely on the standards described below for purposes of §§ 4942, 4945 and 4966 (as applicable). Although regulations may adopt different standards from those referenced below, those regulations will apply to grants made by private foundations and sponsoring organizations no sooner than the date that the regulations are proposed. The standards set forth below will apply with respect to any grants made prior to that date.

In determining whether a disqualified person with respect to a private foundation controls a supporting organization or one of its supported organizations, the control standards established in Treas. Reg. § 53.4942(a)-3(a)(3) will apply. Under these standards, an organization is controlled by one or more disqualified persons with respect to a foundation if any such persons may, by aggregating their votes or positions of authority, require the supporting or supported organization to make an expenditure, or prevent the supporting organization or the supported organization from making an expenditure, regardless of the method by which the control is exercised or exercisable.

Similarly, in determining whether a donor or donor advisor or a person related to a donor or donor advisor (as described in § 4967(d) and 4958(f)(7)) of any donor-advised fund controls a supported organization of the grantee, the control standards established in Treas. Reg. § 53.4942(a)-3(a)(3) will apply. Under these standards, a supported organization is controlled by one or more donor or donor advisors (and any related parties) of any donor-advised fund if any such persons may, by aggregating their votes or positions of authority, require a supported organization to make an expenditure, or prevent a supported organization from making an expenditure, regardless of the method by which the control is exercised or exercisable.

Also, solely for purposes of a representation or opinion of counsel on which a grantor may rely, an organization will be considered a functionally integrated Type III supporting organization if it would meet the test set forth in Treas. Reg. § 1.509(a)-4(i)(3)(ii).

117. IRS Notice 2008-6, 2008-3 I.R.B. 275.

VII. THE CASE AGAINST THE ATTACK ON DONOR-ADVISED FUNDS AND SUPPORTING ORGANIZATIONS

There are many reasons that the Congressional and IRS attack on donor-advised funds and supporting organizations is misguided. The PPA's amendments relating to donor-advised funds and supporting organizations are terrible tax policy and even worse public policy. Donor-advised funds and supporting organizations are an essential component of continuing community-based charitable work. The history of both donor-advised funds and supporting organizations makes it obvious that these charitable giving vehicles are among the most efficient and cost-effective ways to ensure that charitable gifts are actually used for the intended charitable purpose. With little more than anecdotal evidence of serious abuses, Congress has hindered the ability of charitable organizations to continuously fund successful and on-going charitable projects and threatened the existence of essential community charities.

A. Bad Tax Policy

1. Targeting Donor-Advised Funds and Supporting Organizations to Raise Revenue or Close the Tax Gap is Unsound Policy

Tax rate reductions on businesses and individuals coupled with a ballooning deficit have resulted in Congress seeking other ways to raise revenue. The PPA increased penalty taxes in a number of areas, including those on tax preparers who fail to comply with a number of complex new tax laws adopted in the PPA. The provisions relating to donor-advised funds and supporting organizations increased the penalty excise taxes significantly and added confusing new provisions to the Code, especially relating to supporting organizations and, in particular, Type III integrated and non-integrated supporting organizations.[118]

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118. One might have expected there to be an outcry from sponsoring organizations of donor-advised funds and supporting organizations regarding these provisions. There was opposition to these amendments but not to a great degree. This is best explained by the fact that the original provisions in the Senate bill were even more oppressive. For example, in the Senate bill, excise taxes on more-than-incidental benefits would have applied to the entire distribution, not just the benefit. Thus,

> if a donor advised that a grant of $1,000,000 be awarded to a university, and the university gave the donor football tickets worth $1,000, the donor could be subjected to a 25% excise tax on the whole $1,000,000, resulting in a $250,000 penalty that is entirely out of proportion to the $1,000 benefit.

Congress enacted these burdensome changes and now expects the IRS to aggressively implement their enforcement as a means of "closing the tax gap."[119] In theory, increased penalties and stricter regulation of donor-advised funds and supporting organizations should result in greater tax revenues; however, this is not necessarily the case.

The Treasury Department's Office of Tax Policy has studied the issue of reducing the tax gap and provided "an aggressive strategy" and specific recommendations to Congress,[120] which Congress has ignored. In setting its strategy, the Treasury noted three primary characteristics of the tax gap:

> (1) Over 70% of the gross tax gap is attributable to the individual income tax;
> (2) Over 80% of the gross tax gap is caused by underreporting of tax, with roughly half of this amount attributable to underreporting of net business income by individuals; and
> (3) Noncompliance is highest among taxpayers whose income is not subject to third-party information reporting or withholding requirements.[121]

Treasury stressed that reforming and simplifying the tax law would reduce the opportunity for tax evasion "*and make it easier for the IRS to administer the tax laws*."[122]

The Treasury Department stated that:

> The complexity of the tax law also contributed to the tax gap because limited IRS resources are increasingly committed to administering a wide array of targeted tax provisions *created to meet social policy goals*. These targeted provisions, which themselves are growing increasingly complicated, divert IRS resources from basic compliance efforts.[123]

See ABA Tax Section, Letter Questioning Need for Some Charitable Incentives in Senate Tax Reconciliation Bill (S. 2020) (Feb. 6, 2006).

119. The "tax gap" refers to the difference between what the IRS actually collects and what taxpayers should be paying in taxes.

120. U.S. Department of the Treasury, Office of Tax Policy, A Comprehensive Strategy for Reducing the Tax Gap (Sept. 26, 2006).

121. Id. at 5.

122. Id. at 3 (emphasis added).

123. Id. at 15 (emphasis added). On Aug. 3, 2007, an IRS investigator told the House Ways and Means Committee that charitable organizations were responsible for nearly $1 billion in unpaid federal payroll taxes in 2006. CCH, Treasury Delivers Tax Gap Plan to Baucus (Aug. 3, 2007). This is an area in which the IRS should be able to

Although Treasury was not referring to any specific tax provisions, it could not have described the enactment of the new IRC provisions related to donor-advised funds and supporting organizations more accurately. Nowhere are the new tax provisions more complex and confusing than in the PPA's creation of the new categories of functionally integrated and non-functionally integrated Type III supporting organizations and the new restrictions directed at Type III supporting organizations that are not functionally integrated.[124]

Finally, in its report, Treasury noted that penalties were useful in deterring noncompliance with the Code, but if penalties are set too high, examiners may be "unable or unwilling to assert them, particularly when they believe the taxpayers may have made inadvertent errors."[125]

2. There Is No Rationale to Treat Donor-Advised Funds and Supporting Organizations More Harshly Than Other Exempt Organizations

The PPA's establishment of a new type of automatic excess benefit transactions between a charity and disqualified persons applies exclusively to donor-advised funds and supporting organizations.[126] The Tax Section of the American Bar Association (ABA) responded critically to Congress' enactment of these provisions.[127] From the time these provisions were enacted, this author has failed to find any possible rationale for such harsh treatment exclusively directed at donor-advised funds and supporting organizations. Similarly, the ABA could find no explanation for these changes to the automatic excess benefit transactions amendments. The ABA stated:

> It is not clear why supporting organizations and donor-advised funds should be subject to a more stringent rule [than private foundations or other exempt charitable organizations]. Implicit

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achieve greater compliance without expending an inordinate amount of resources. See also infra note 128 and accompanying text.

124. These new provisions

> are a source of significant complexity and have resulted in significant confusion. The statutory definitions are ambiguous … We encourage the Oversight Committee to reconsider these rules. If Congress decides to retain these rules, the Oversight Committee should monitor how the Treasury Department carries out it broad regulatory authority to ensure that these provisions do in fact address the reported abuses that led to their enactment.

ABA Tax Section, Letter to Congressional Leaders on Pension Protection Act of 2006 Provisions Affecting Exempt Organizations (Aug. 8, 2007).

125. Id. at 9.

126. IRC § 4958(c)(2), (3).

127. See supra note 123.

> in this change must be the view that payments of compensation or expense reimbursements to disqualified persons by supporting organizations or donor advised funds are more likely to result in abuse than similar payments by private foundations. *However, we are not aware of any substantial evidence to that effect*.[128]

The ABA also complained that the PPA provisions result in non-functionally integrated Type III supporting organizations being treated more harshly than private foundations. The Code provides that a grant from one private foundation to another private foundation may qualify as a qualifying distribution that counts against the minimum distribution requirements under the "out of corpus" rules of IRC section 4942(g)(3). There is no flexibility for this treatment of grants by private foundations to non-functionally integrated Type III supporting organizations.[129]

3. The IRS Had the Tools Needed to Resolve Issues of Excess Benefits Prior to the PPA's Amendments

The IRS has always had the ability to prevent charitable organizations from permitting the private inurement of private shareholders or individuals (insiders) and conferring excessive benefits upon any person, other than a member of the charitable class, whether or not an insider.[130] As the New York Community Trust stated:

> The law governing charitable contribution deductions (Section 170 of the Code and the accompanying Treasury Regulations, court case and so forth) quite clearly provides that a gift to a charity that provides impermissible private benefits to the donor or another private individual is not tax-deductible. To create special rules and regulations for contributions to donor-advised funds that are part of a functioning public charity

128. Id. (emphasis added). The ABA also stressed that the PPA amendments to the excess benefit transaction provisions reversed the priorities of IRC § 4941 [the self-dealing provisions that apply to private foundations] by prohibiting the payment of compensation but allowing sales and leases. "Congress previously had determined in enacting § 4941 that sales and leases were more susceptible to abuse than compensation for services, but the PPA takes a contradictory approach." The ABA added that the "rules under § 4941 already were subject to much criticism for their complexity, and by prohibiting the payment of all compensation by supporting organizations and donor-advised funds the PPA effectively creates more traps for the unwary."

129. Id.

130. See supra note 6 and accompanying text.

> does not add anything material to existing law. The need is for best practices and oversight by sponsoring organizations and donors and for enforcement by the IRS: new and redundancy special rules will only create a maze of foot faults.[131]

4. Facts and Circumstances Test is Meaningless and Unworkable in These Situations, and the Impact on Smaller Exempt Organizations is Disproportionate

As explained earlier, the PPA's amendments impacting sponsoring organizations, donor-advised funds, and supporting organizations have added a host of new complexities to the provisions governing the operation of these organizations. The IRS made repeated attempts to explain the operation of the intermediate sanctions provisions before finally releasing final regulations after six years. The IRS is still grappling with this issue and continues to try to formulate understandable guidance.

Complex tax provisions often require the IRS to adopt a "fact and circumstances" test to determine whether a charitable organization has violated provisions regarding private inurement or private benefit, more-than-incidental benefits, and self-dealing provisions. Now, the IRS and charitable organizations will have to perform complicated, time-consuming work to determine such things as whether an organization is a Type III supporting organization, whether a donor or some other person is a disqualified person, whether the transaction was intentional or unintentional, and the value of the benefit. This will be no easy task. Applying the facts and circumstances test to these issues will inevitably lead to disparate results in similar circumstances. The potential for the IRS to target certain types of organizations is also an issue.

The facts and circumstances test is really no test at all. In *United Cancer Council, Inc. v. Commissioner of Internal Revenue*,[132] the IRS objected to a small charity that had hired an outside fundraising organization to raise money for the organization. The contract was an arm's-length transaction and the IRS never claimed that any of the funds paid to the fundraising organization found its way into the "pockets of any members of the charity's board."[133] Nor did the IRS contend "that any members of the board were owners, managers, or employees of the fund-raising organization." Nor did the IRS claim that the fund-raising organization had any direct or indirect involvement in the creation of the

131. Statement of New York Community Trust to the House Ways and Means Committee (Jul. 24, 2007).

132. 165 F.3d 1173 (7th Cir. 1999).

133. Id. at 1175.

charitable organization or the organization's goals.[134] Instead, the IRS contended that the contract was so disadvantageous to the charitable organization that the "charity must be deemed to have surrendered control of its operations and earnings" to the fund-raising organization.[135]

In the court's opinion in *United Cancer Council*, Judge Posner seemed incredulous that these were the IRS's assertions. He explained that the private inurement provisions had long been understood to refer to insiders of the charitable organization.[136] He explained:

> The [inurement] provision is designed to prevent the siphoning of charitable receipts to insiders of the charity, not to empower the IRS to monitor the terms of arm's length contracts made by charitable organizations with the firms that supply them with essential inputs, whether premises, paper, computers, legal advice or fundraising services.[137]

The court rejected the IRS's decision to revoke the charitable status of the organization on these grounds. Judge Posner's description of the "facts and circumstances" test in these situations was pointed and accurate:

> We were not reassured when the government's lawyer, in response to a question from the bench as to what standard he was advocating to guide decision in this area, said that it was the "facts and circumstances" of each case. That is no standard at all, and it makes the tax status of charitable organizations and their donors a matter of the whim of the IRS.[138]

The PPA's amendments will result in organizations either opting for a "better-safe-than-sorry" approach that will make them much less effective at attracting charitable-minded people to set up a donor-advised fund, or force these organizations to waste vital resources in an attempt to comply with these confusing tax laws. Currently, supporting organizations have been able to distribute 98-99% of their funds because they were not handcuffed with burdensome over-regulation, as are private foundations. The result is that distributions will likely sink to the 60-80% level of private foundations.

An often-overlooked consequence of the PPA's amendments to the donor-advised fund provisions is the fact that elimination of all distributions

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134. Id.
135. Id.
136. Id. at 1176.
137. Id.
138. Id. at 1179.

from donor-advised funds to individuals and to for-profit companies that do not conduct charitable activities eliminates the ability of these funds to pay vendor expenses incurred during fundraising events. This particularly impacts smaller donor-advised funds and will serve to discourage donors from raising additional money for these funds.[139]

B. Bad Public Policy: PPA Amendments Dissuade Donors from Establishing Donor-Advised Funds and Being Actively Involved in the Charitable Issues that Matter Most to Them

Community foundations first developed donor-advised funds to encourage donors to invest in the present and future needs of their community. These funds allow permanent charitable organizations to consolidate many grants from different types of funds to support community endeavors in order to provide for the future well-being of their communities.[140] Donor-advised funds offer many advantages to both community foundations and to donors as compared to private foundations or individual contributions to exempt organizations.

First, there is no question that some organizations that have exempt tax status are scams. The overhead costs result in a miniscule use of funds for the intended charitable purpose. Donors must expend much time and energy to ascertain the legitimacy and efficiency of the thousands of charitable organizations seeking their support. It is likely that many well-intentioned donors give contributions to organizations that have no intention of using the donations as the donor expects. This unfortunate result is highly unlikely when contributions are made to donor-advised funds.

Sponsoring organizations of donor-advised funds play a crucial role in ensuring that a donor's funds are actually used for the intended charitable purpose, instead of leaving donors to simply guess which charitable organizations they can entrust with their direct gift. Donor-advised funds educate donors about priorities important to the community and serve to create a broad base of support for charitable endeavors that support the community.[141] Donor-advised funds "engage and educate donors" and build lasting endowments to benefit the community.[142] Community foundations also serve to insure that all

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139. See, e.g., North Virginia Community Foundation Comments on IRS Notice 2007-21 on Donor-Advised Funds, Supporting Organizations (Mar. 30, 2007).

140. See generally supra note 123.

141. See, e.g., BNA, UJC Opposes Overregulation of Donor-Advised Funds, Cites Advantages of Organization Type (Apr. 13, 2007). The United Jewish Communities represents 155 Jewish service organizations and claims to be the nation's largest holder of donor-advised funds. Id.

142. North Virginia Community Foundation Comments on IRS Notice 2007-21 on Donor-Advised Funds, Supporting Organizations (Mar. 30, 2007).

grants from donor-advised funds go to bona fide nonprofits in good legal standing.[143]

Second, "98-99% of every dollar that flows into a Donor Advised Fund is available for grant making to nonprofits in the community."[144] This is in stark contrast to the percentage that most private foundations are able to grant for charitable purposes.[145] "Most private foundations only manage to grant out between 60%-80% of the input dollars."[146]

Third, supporting organizations provide the expertise to ensure that a donor's funds are disbursed to organizations that meet the requirements for exemption under the Code. Moreover, the expertise of fund managers coupled with the involvement of donors serves as a double-check that funds are being used wisely. It seems obvious that an informed donor working with fund managers that do not want to risk the credibility or the exemption status of their sponsoring organization are more likely to make charitable contributions to organizations that are fiscally responsible and committed to their charitable purpose.[147] "In addition to providing guidance on the selection of grantees, the sponsoring organization provides an extra layer of oversight and necessary administration that is otherwise difficult for individual donors or unstaffed family foundations to manage.[148]

Finally, the PPA's amendments have created a situation in which donors are discouraged from being actively involved in the charitable issues that most matter to them.

VIII. CONCLUSION

The PPA's amendments have threatened the ability of sponsoring organizations, donor-advised funds, and supporting organizations to perform their vital charitable services and provide essential resources to communities across the country. At the same time, these amendments have forced the IRS to focus on an area that will not result in much additional tax revenue and an area in which the IRS has shown a tendency to act abusively. The PPA's amendments are terrible tax policy – and even worse public policy.

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143. Id. "By virtue of the collaboration between donors and community organizations through donor advised funds, donors have ready access to information about community needs and the nonprofits meeting those needs." This often results in donors making sound recommendations that meet community needs. Id.

144. Id.

145. Id.

146. Id.

147. See generally Journal of Accountancy, More Restrictions May Await this Popular Way to Give (Jan. 2008) (Online Issues, www.aicpa.org/pubs/jofa/jan2008/donor_advised_funds.htm).

148. Supra note 130.