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**IRS REVOKES PRIVATE LETTER RULING ON EARLY TERMINATION &
DIVISION OF CHARITABLE REMAINDER TRUSTS**

We have reported that Private Letter Rulings frequently authorize the early termination of a Charitable Remainder Trust, with the appropriate division of the assets between the charity and the non-charitable beneficiary (including below). In P.L.R. 200525014, the IRS found no act of self-dealing in such a termination and that it did not constitute a termination of foundation status under I.R.C. Section 507(a). However, in P.L.R. 200614032, the service specifically revoked the earlier P.L.R. This presents an important issue. Why did the IRS revoke? Commentators have suggested that the Remainder Charitable Beneficiary being a private foundation was an issue (see P.L.R. 200616035 noted below) and commentators have indicated that the IRS's concern was based on the fact that this particular Charitable Remainder Trust was a net income version with a 15% payout rate. This higher payout rate results in a significantly higher amount going to the income beneficiary upon termination. This would be a motivation for grantors to terminate such trusts. Taken together, P.L.R. 200614032 and P.L.R. 200616035 (below) indicate the IRS will approve terminations if the parties each receive a fair actuarial distribution, and the remainder charity is not a private foundation.

**GOOD PLANNING PAYS OFF—OVERCOMING EARLIER IRS DENIAL OF
FAVORABLE TREATMENT FOR EARLY TERMINATION OF CRUT**

The IRS has ruled again that early termination of a Charitable Remainder Unitrust (CRUT) will not be treated as an act of self-dealing and will not subject the trust to the termination tax under I.R.C. Section 507. The original P.L.R. was favorable to the taxpayer. Then the original P.L.R. was revoked. This letter ruling revokes the earlier denial of the taxpayer's request. Apparently, the taxpayer's original P.L.R. was revoked because the remainder beneficiary was a private foundation. The taxpayer resubmitted its request after modifying the trust to provide that only publicly supported organizations under I.R.C. Section 509(a) would be remainder beneficiaries. The grantor was able to accomplish this because the CRUT had an optional provision permitting him to change the charitable remainderman. Good planning pays off. P.L.R. 200616035.

**IRS PERMITS CHARITABLE REMAINDER ANNUITY TRUST TO DISTRIBUTE
EXCESS INCOME TO CHARITABLE REMAINDERMAN DURING LIFE OF
INCOME BENEFICIARY**

The IRS has ruled that the modification of a Charitable Remainder Annuity Trust by the trustee (who was also the charitable remainderman) that would permit distributions of excess income to the charitable remainderman during the remaining term of the trust, will not disqualify the trust under I.R.C. Section 664. The general rule is that there be only one income interest at a time and that the remainder go to a qualified organization. However, the regulations permit these kinds of trusts to include a provision that allows transfer of excess income or principal to the charity prior to the termination of the trust.

Reg. Section 1.664—3(a)(4). In this case there was no provision in the trust for that to occur. However, the trustee/charity prevailed upon the income beneficiary to consent to reform of the trust to permit such distributions. A local court approved the change subject to a favorable letter ruling from the IRS, which has now been issued. P.L.R. 200617026.

LEGISLATIVE UPDATE

As you may know, the legislation to reform exempt organizations and charitable giving did not pass Congress as expected. However, the provisions are still on the table according to Senate Finance Committee leadership. It is still hoped that the legislation will pass, possibly including a provision permitting tax-free rollover of IRAs to charities. If the legislation passes in the very near future, we will issue a special edition of our newsletter. See previous articles: Threats to Charitable Organizations and Giving; and Recommendations of the President's Advisory Panel on Tax Reform that Affects Charities and Charitable Giving.

COMMUNITY BENEFIT STANDARD

The issue of the so-called Community Benefit Standard was discussed at the Great Lakes Exempt Organizations Council Meeting at IRS offices in Chicago. This is a standard that started with the IRS's examinations of the health care industry. The concept is that an organization is not entitled to an exemption from taxation unless it provides some community benefit. Originally, the issue revolved around whether the organization provided free or charity care. Over the years the standard has developed and the IRS has determined, for example, that bad debt write-off is not considered free or charity care. Moreover, aggressive collection techniques are a negative in determining whether there is a community benefit. The IRS says that their new Compliance Check Program will include this issue.

Charity care is no longer the only measure. The IRS does recognize that an organization can provide a community benefit even though it sells its services. One of the things the IRS looks for is a board that is fairly representative of the community being served. They see a community board as providing accountability. Renee B. Wells, Great Lakes Area Manager for Exempt Organizations, says that the community benefit standard applies to other than health care organizations and that the standard developed in the health care industry will be used as a basis for the Community Benefit Standard with respect to non-health care industries.

Current activity in this area includes possible legislation from the House Ways and Means Oversight Sub-Committee and the Senate Finance Committee. Also, the IRS is working more closely with State Attorneys General. There is a growing commitment to the charity care policy. See www.ag.state.mn.us. A model in this area is the Catholic

Health Association Community Benefit Guidelines and Standard Definitions. Their web address is www.chausa.org. For more information on this subject, see IRS Rev. Rul. 56-185, Rev. Rul. 69-545, Rev. Rul. 83-157, and 2001 Field Service Memo F.S.A. 200110030 (February 5, 2001), and IRS F.Y. 2002 C.P.E. Text-Health Care Update.

EMPLOYMENT TAXES

Almost every exempt organization examination by the IRS involves some employment tax adjustments. The major problems are: misclassification (employers incorrectly treating employees as independent contractors instead of employees); payroll returns (failure to file); Form 1099 vs. Form W-2 (related to misclassification issue); and accountable plans (benefits paid to employees as reimbursement for business expenses, but without appropriate accountability to determine if the amount paid by the employer matches the actual expense). In the case of an officer, payments that are not treated as wages may be automatic excess benefits which will entail excise taxes, as well as employment tax and interest and penalties, and income tax, interest and penalties. This is an area you should watch very closely.

POLITICAL ACTIVITY BY SECTION 501(c)(3) ORGANIZATIONS IS A REAL HOT BUTTON ISSUE WITH IRS

As a result of numerous complaints during the 2000 election, the IRS is making a pointed and concerted effort to enforce the prohibition on 501(c)(3) organizations engaging in political activity. They have established a team and a procedure for expeditiously handling such complaints in the future and it is called the Political Activity Compliance Initiative (P.A.C.I.). This team addresses all referrals, which allege that a 501(c)(3) organization has participated in, or intervened in, a political campaign on behalf of, or in opposition to, any candidate for public office. In addition to acting on referrals, the P.A.C.I. will leverage available resources to identify other areas of potential non-compliance, and take action to prevent violations.

Make no mistake, they are deadly serious about this and have allocated adequate resources to this initiative. This comes from the very highest levels of the IRS. The IRS Commissioner, Mark Everson, personally introduced this in a speech on February 24, 2006. He pointed out that the prohibition is contained in Section 501(c)(3) and that the rule against intervention by charities and churches in political campaigns has been entrenched in the law for over half a century. The courts have consistently upheld the prohibition. The U.S. Supreme Court has held that, in essence, the tax exemption is a privilege, not a right, stating, "Congress has not violated [an organization's] First Amendment Rights by declining to subsidize its First Amendment activities." He went on to discuss the dramatic increases in the amount of money involved in political campaigns and posed the question: "Are we going to let these political activities spread to our charities and churches? Now is the time to act, before it is too late."

In the first initiative, the IRS opened 132 reviews. They resulted from specific referrals. Twenty-two of the cases were closed as not meriting any further review. But, 75% of the 82 examinations completed to date substantiated that the charities or churches engaged in prohibited political activity.

What should be frightening here is that the vast majority of the cases were initiated by referrals. In other words, complaints from the candidate who was not favored or from supporters of that candidate. Do not think that the field is too big for the IRS to adequately police it because the offended parties are actually policing it. Of the churches reviewed, 84% were found to be in violation.

You also cannot rely on the issue becoming moot because the IRS can't get to it before the election. This new initiative provides an expedited process under which every one of the complaints received from the 2004 election were addressed well before the election. All church cases are conducted according to the Church Tax Inquiry and Examination Procedures of I. R.C. Section 7611 to protect the separation of church and state.

You might be surprised at what is considered political activity. Among other things, it includes:

- (1) Charities, including churches, distributing diverse printed materials that encourage that their members vote for a particular candidate;
- (2) religious leaders using the pulpit to endorse or oppose a particular candidate;
- (3) charities, including churches, endorsing or opposing a candidate on their website or through links to another website;
- (4) charities, including churches, disseminating improper voter guides or candidate ratings that encourage readers to vote for a particular candidate;
- (5) charities, including churches, placing signs on their property to show that they support a particular candidate;
- (6) charities, including churches, giving improperly preferential treatment to certain candidates by permitting them to speak at functions;
- (7) individual activity by charity or church leaders;
- (8) issue advocacy by charities, including churches that are transparent attempts to endorse or oppose a particular candidate.

See I.R.-2006-36, "Political Activity Guidance for Tax Exempt Organizations" (available on the IRS website—go to the "Charities & Non-Profits" tab), and the Report of Election

Year Activities and the Prohibition on Political Campaign Intervention for Section 501(c)(3) Organizations”, also available on the IRS website.

These activities are governed by I.R.C. Section 4955, which includes penalties for political expenditures, on both the organization and the manager who authorizes it. See also I.R.C. Sections 4952 and 4958.

BRIEFS

- In P.L.R. 200618023, the IRS permitted the Executor to fulfill charitable bequests under the decedent’s Will with a nonqualified tax-deferred annuity contract that had no yet reached its annuity start date. The annuity had no designated beneficiary, and under state law the annuity became payable to the estate. The result of using the annuity to fulfill the bequest is that the income in respect of decedent (I.R.D.) will only be included as income by the charities; and the assignment will not be treated as a transfer within the meaning of I.R.C. Sec. 691(a)(2). The decision was also based on Regs. Secs. 1.691(a)—4(b) and 1.691(a)—(v)(2), and Rev. Rul. 2005-30, 2005-20 I.R.V. 1015.
- The U.S. Court of Federal Claims found that a charity was not operated for charitable purposes and thus was not entitled to an exemption. Essentially, the charitable entity administered some donor advised funds that were used to reimburse the donors’ charitable expenses and also compensated the donors for volunteer services. *New Dynamics Foundation v. United States, United States Court of Federal Claims No. 99-1971 (April 24, 2006)*.
- The Joint Economic Committee of the U.S. Congress conducted a study and found that “there is no compelling reason to keep the [estate] tax and a number of reasons to reduce or abolish it.” In the opinion of the report, the estate tax impedes economic growth, hinders entry into self-employment and breaks up family-run businesses and is an impediment to upward income and wealth mobility. They found it to be an ineffective tool for fighting wealth and income inequality. They also found that the benefits of the charitable deduction are overstated, with recent research indicating the tax has only a modest, if any, impact on gifts to charities. You can find the full report at their website: www.house.gov/jec/.
- The Florida legislature has repealed the Florida Intangible Personal Property Tax, effective as of January 1, 2007. There has never been a state income tax in Florida but the intangible personal property tax has been an issue for people looking to Florida as a tax haven. This now makes Florida more attractive in that regard. For more information on the intangible personal property tax as it was, go to www.myflorida.com/dor .

- The IRS has ruled that reasonable attorney fees incurred in splitting a Charitable Remainder Trust into two parts upon the divorce of the creators can be paid from trust corpus. P.L.R. 200616008.
- We have written previously about the value of disclaimers in post-death planning. The IRS has now ruled that a qualified disclaimer of an interest in a trust that causes property to pass to a private foundation will be entitled to a charitable deduction under I.R.C. Section 2055. P.L.R. 200616026.

To find the cases, statutes and rules cited in this newsletter, try the following free websites:

www.findlaw.com

www.firstgov.gov

www.access.gpo.gov

www.irs.gov

www.law.cornell.edu

“But remember the LORD your God, for it is he who gives you the ability to produce wealth, and so confirms his covenant, which he swore to your forefathers, as it is today.”

Deuteronomy 8:18