A. THE DEFICIT REDUCTION ACT OF 1984 – PRIVATE FOUNDATIONS AND MISCELLANEOUS PROVISIONS

The Deficit Reduction Act of 1984 (DEFRA) contains many provisions that change the law applicable to exempt organizations. These changes are so extensive that the subject has been divided into three topics in this CPE text, as follows:

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PRIVATE FOUNDATIONS

1. Background

In 1983, Congress made its first extensive review of the private foundation provisions of the Tax Reform Act of 1969 with the stated purpose of determining how well these provisions were working in practice. The subcommittee on Oversight of The House Ways and Means Committee conducted public hearings in June 1983 and received suggestions as to what extent the 1969 provisions should be liberalized or tightened. The Ways and Means Committee ultimately incorporated some of these suggestions in the Tax Reform Act of 1983 (H.R. 4170). Most of the adopted suggestions involved liberalizations and exceptions to the existing private foundation restrictions. H.R. 4170, however, failed to clear the House in the 1983 Session.

H.R. 4170 was reintroduced in the 1984 Session with its private foundation provisions substantially unchanged from those of the 1983 bill. It passed the House on April 11, 1984, as part of the Tax Reform Act of 1984. The Senate version of this legislation, passed on April 13, contained minor differences that were resolved in conference. The Tax Reform Act was merged with other legislation to become part of the Deficit Reduction Act, which was signed into law by the President on July 18, 1984.

2. Deduction Limitations Revised

(A) Prior Law

Before DEFRA, an individual could not receive an income tax deduction for any contributions made to a private nonoperating foundation to the extent that the contributions exceeded 20% of the individual's adjusted gross income. IRC 170(b)(1)(B)(i). There was no carryover to subsequent years for contributions over the 20% limit. In addition, deductions for contributions of capital gain property to private nonoperating foundations were reduced by 40% (28/46 in the case of a corporation) under IRC 170(e)(1)(B)(ii).

In contrast, cash and ordinary income contributions to public charities and private operating foundations by an individual were limited to 50% of adjusted gross income, while contributions of capital gain property had a limitation of 30% of AGI. Contributions in excess of these amounts could be carried over for five years. The 40% and 28/46 reductions under IRC 170(e)(1)(B)(ii) for gifts of capital gain property did not apply to contributions to public charities and operating foundations.

(B) DEFRA Changes

No changes were made with respect to deductibility of contributions to public charities and to operating foundations. Prior law remains in effect for these entities. For private nonoperating foundations, DEFRA provides:

(1) The contribution limit of 20% of AGI for cash and ordinary income contributions by individuals to nonoperating foundations is raised to 30%.

(2) The contribution limit of 20% of AGI for contributions of capital gain property by individuals to nonoperating foundations is retained.

(3) To the extent the contributions exceed the 30% limit (or the 20% limit for capital gain property), a five year carryover is allowed.

(4) Beginning July 19, 1984, and through December 31, 1994, contributions to nonoperating foundations by either an individual or a corporation of stock in a publicly traded corporation are not subject to the 40% reduction (or 28/46 reduction in the case of a

corporation) for capital gain property imposed by IRC 170(e)(1)(B)(ii). However, for these purposes, this exception to the 40% reduction does not apply to the extent a donor makes a contribution of more than 10% of the total stock of any corporation, or to the extent a donor makes any series of contributions that results in the 10% limit being exceeded. Amounts contributed in excess of the 10% limit at any time will be subject to the 40% reduction.

(C) Effective Date

(1) Both the change in percentage limits on deductibility of contributions to nonoperating foundations and the new 5-year carryover provisions apply to contributions made in taxable years ending after July 18, 1984. Thus, for a calendar year taxpayer, these changes are effective for contributions made at any time during 1984.

(2) The rule providing for an exception to the 40% reduction in contributions of capital gain property in the case of publicly traded stock is effective only for contributions made after July 18, 1984 and before January 1, 1995.

[Chart not shown here]

3. IRC 4940 Excise Tax Provisions Relaxed in Some Cases

DEFRA has provided for two liberalizations of the IRC 4940 2% annual excise tax on net investment income. One change is applicable only to private operating foundations; the other to private foundations generally.

(A) Elimination of IRC 4940 Tax for Exempt Operating Foundations (EOF's)

Before DEFRA, all private operating foundations were subject to the 2% annual excise tax on net investment income. DEFRA eliminates this tax for those private operating foundations that are classified as "exempt operating foundations".

(1) Exempt Operating Foundation (EOF) Defined

Under new IRC 4940(d), an EOF is a private foundation that

(a) is a private operating foundation under IRC 4942(j)(3);
(b) has been publicly supported for at least 10 taxable years, <u>or</u> was a private operating foundation described in IRC 4942(j)(3) on January 1, 1983;
(c) at all times during the taxable year in question, no more than 25% of the governing body of the foundation is composed of "disqualified individuals";
(d) the governing body during the entire taxable year is broadly representative of the general public; and
(e) at no time during the taxable year does the foundation have an officer who is a disqualified individual.

For purposes of IRC 4940(d), a "disqualified individual" means an individual who is a substantial contributor to the foundation (as defined in IRC 507(f)(2)); an individual described in IRC 4946(a)(1)(C) (relating to 20% ownership in a corporation or enterprise that is a substantial contributor); or a member of the family of either of the above. The term "disqualified individual" is narrower than "disqualified person" because it does not include foundation managers, exempt, or nonexempt organizations.

The greatest impact of IRC 4940(d) is likely to fall on private operating foundations already in existence on January 1, 1983. If these operating foundations meet the composition requirements for their officers and governing boards, they will automatically qualify as EOF's and avoid the 2% tax of IRC 4940(a).

However, organizations that achieve private operating foundation status after January 1, 1983, must meet the 10-year public support test to qualify as EOF's. Public support, for these purposes, means satisfying the requirements of IRC 170(b)(1)(A)(vi) or IRC 509(a)(2). Because organizations that satisfy the public support test are likely to seek classification as public charities rather than as EOF's, the 10-year test will likely have application only where a public charity that meets the IRC 170(b)(1)(A)(vi) and IRC 509(a)(2) requirements for 10 years, and finds that it can no longer meet these requirements in subsequent years, seeks EOF status as an alternative.

Congress also provided another benefit for EOF's in excepting donors to EOF's from expenditure responsibility rules under IRC 4945(d)(4). See section 6 of this topic.

(B) Reduction of IRC 4940 Tax From 2% to 1% if Certain Distribution Requirements are Met

(1) The Stick

Under current law, all private foundations are required to meet the distribution requirements of IRC 4942. Unless a nonoperating foundation meets these requirements, it will be subject to the excise tax on failure to distribute income of IRC 4942(a). Likewise, an operating foundation will lose its status if it fails to make a certain minimum amount of qualifying distributions directly for the active conduct of its exempt activities as required by IRC 4942(j)(3).

(2) The Carrot

Congress adopted IRC 4940(e) in DEFRA in order to provide private foundations with an incentive to increase their distributions above the minimum required by IRC 4942. If the distribution requirements of new IRC 4940(e) are met, the tax imposed by IRC 4940(a) will be reduced from 2% to 1% of net investment income. This incentive is available to all private nonoperating foundations and to those private operating foundations that are not exempt operating foundations. As discussed above, EOF's do not pay IRC 4940 taxes.

(3) The Computation

To qualify for the IRC 4940(e) reduction, a private foundation must make qualifying distributions (or, in the case of a private operating foundation, must make qualifying distributions directly for the active conduct of its exempt activities) in an amount equal to the sum of:

(A) the foundation's assets in the taxable year in question multiplied by the foundation's average percentage payout over a 5-year base period; and

(B) 1% of the foundation's net investment income for the taxable year.

In addition, there is a threshold requirement that the average percentage payout over the base period must be at least 5% for a private nonoperating foundation, and 3 1/3% for a private operating foundation. Finally, the reduction is not available in the taxable year if, for any base period year, the foundation incurred liability for tax under IRC 4942.

For purposes of this computation, the 5-year base period is the 5-year period immediately preceding the taxable year. If a foundation has not been in existence for 5 years, the base period is the time the foundation has been in existence. A newly formed organization in its first taxable year, however, has no base period and is not eligible for a reduction in its first year.

The term "assets", as used in IRC 4940(e), refers to the fair market value of the foundation's assets, other than those used or held for use directly in carrying out the foundation's exempt purposes, less acquisition indebtedness with respect to those assets.

One other special rule should be noted for purposes of the IRC 4940(e) computation. For any base period year in which the IRC 4940 tax was reduced under the provisions of IRC 4940(e), the amount of qualifying distributions to be taken into consideration for that base period year will be reduced by the amount of the tax reduction for that year.

EXAMPLE:

A private nonoperating foundation has assets of $ 100,000 in the taxable year in question. Qualifying distributions for the taxable year equal $ 5,500, and net investment income is $ 10,000. The data for the base period years are:

[Data not shown here]

The first step is to compute the percentage payout for each year, as follows:

[Computation not shown here]

The percentage payout figures are then averaged, with the result in this case being 5.333%. Because this exceeds the 5% average payout requirement, the threshold requirement of IRC 4940(e) is met. Likewise, although the percentage for year 5 is less than 5%, the foundation would not have incurred tax liability under IRC 4942, and consequently would not be disqualified from receiving the

1% reduction, because it would have been allowed a carryover of its excess qualifying distributions from prior years under IRC 4942(i).

The 5.333% average payout is then multiplied by the foundation's assets for the current year. $ 100,000 times 5.333% equals $ 5,333. Add 1% of the net investment income for the taxable year to this figure. 1% of $ 10,000 equals $ 100; $ 100 plus $ 5,333 equals $ 5,433. Because qualifying distributions for the taxable year ($ 5,500) exceed $ 5,433, the foundation qualifies for the IRC 4940(e) reduction.

(4) The Effect

IRC 4940(e) allows a foundation to distribute as qualifying distributions for charitable purposes an amount that would otherwise be used to pay the IRC4940 excise tax. A paradox arising from this provision is that it allows foundations that have distributed lesser amounts during their base period to maintain a lower level of qualifying distributions in subsequent years than organizations with a more substantial history of charitable giving. The reason for this anomaly is that Congress did not want foundations that had been making more qualifying distributions than required to reduce the amount of their distributions and still qualify for the reduction.

(C) Effective Dates

The elimination of IRC 4940 taxes in IRC 4940(d) and their reduction in IRC 4940(e) are effective in taxable years beginning after January 1, 1985.

4. Limitation on Administrative Expenses Taken Into Account as Qualifying Distributions Under IRC 4942; Other Changes to IRC 4942

Under IRC 4942 before DEFRA, a private foundation was allowed to include administrative expenses to an unlimited extent as part of its qualifying distributions. Until December 31, 1990, DEFRA provides a cap on the amount of administrative expenses a foundation can include in its qualifying distributions each year. The cap applies to the qualifying distribution requirements of both operating and nonoperating foundations.

The limit applies only to grant administrative expenses and is 0.65% of the sum of net assets of the private foundation for the taxable year and the two preceding taxable years, less the aggregate amount of grant administrative

expenses paid and taken into account as qualifying distributions in the two preceding taxable years.

The primary effect of this formula is to ensure that, of the 5% of the net assets that a private nonoperating foundation must distribute under IRC 4942(d) and (e), at least 4.35% of that amount, less taxes imposed by IRC 511 and IRC 4940, will be distributed as charitable gifts or grants. The formula takes into account a three year averaging period that would allow a foundation to have grant administrative expenses in excess of 0.65% to the extent it has not used its full allowance in the two earlier years. Conversely, excessive prior year administrative expenses would decrease permissible current year administrative expenses. For years in the averaging period beginning before January 1, 1985, a transitional rule limits the grant administrative expenses that need to be taken into account to 0.65%.

Grant administrative expenses are those administrative expenses directly or indirectly allocable to the making of contributions, gifts, or grants that are qualifying distributions. Certain other administrative expenses that are not grant administrative expenses may be included as qualifying distributions without limitation if they are incurred directly for the active conduct by the foundation of exempt activities of the foundation, or in making program-related investments described in IRC 4944(c). Thus, the administrative expenses of a private operating foundation that are used directly in the active performance of its exempt activities are considered qualifying distributions not subject to the 0.65% limitation.

This limitation takes effect in taxable years beginning after January 1, 1985 and will no longer be effective in taxable years beginning after December 31, 1990. In the meantime, Congress has directed the Treasury Department to study administrative expenses incurred by nonoperating and operating foundations, the amount of qualifying distributions that actually reach charitable beneficiaries, and the effect of the new 0.65% limitation. To carry out this study, Form 990-PF is being modified to request additional information from foundations concerning their expenditures.

Finally, the new law increases the distributable amount under IRC 4942(d)(1) by including returns or repayments of amounts previously taken into account as qualifying distributions.

5. Changes to IRC 4943

(A) Five-Year Extension of the Requirement to Dispose of Excess Holdings Acquired by Gift or Bequest in Certain Cases

IRC 4943(c)(6) allows a 5-year period for private foundations to dispose of excess business holdings acquired by gift or bequest. Because at least one organization with especially large holdings acquired by will was having difficulty in finding a buyer within the 5-year period, Congress enacted IRC 4943(c)(7) which authorizes the Service to allow an additional 5-year period if certain conditions are met.

To qualify for the additional 5-year period, a foundation must:

(1) establish that diligent efforts to dispose of the excess holdings have been made in the initial 5-year period;

(2) establish that because of the size and complexity of the holdings, disposition within the initial 5-year period has not been possible except at a price substantially below fair market value;

(3) before the close of the initial 5-year period, submit a plan to the Service for disposing of the excess holdings in question; and

(4) before the close of the initial 5-year period, submit the plan to the State Attorney General (or other appropriate official), and submit any response from this official to the Service.

Once an application for a 5-year extension has been received, the Service will determine whether the plan can reasonably be expected to be carried out within the additional 5-year period. Any extension under IRC 4943(c)(7) is discretionary with the Service, and all relevant facts and circumstances will be considered.

All requests for IRC 4943(c)(7) extensions will be handled in the National Office.

(B) Exception to Downward Ratchet Rule for Decreases in Holdings Due to Stock Issuances

Under IRC 4943(c)(4)(A)(ii) an organization with "grandfathered" excess business holdings (i.e., excess business holdings held by the foundation on May 26, 1969) is subject to a downward ratchet rule when the percentage of holdings in a business enterprise is decreased. This rule provides that if there is any reduction in the percentage of holdings of the private foundation, or in the percentage of the combined private foundation and disqualified person holdings, then the resulting lowered percentage cannot again be raised to the former grandfathered or otherwise permitted level. Decreases attributable to issuances of stock (or to issuances of stock combined with redemptions of stock) were determined only as of the end of the taxable year unless the aggregate of the percentage decreases due to such issuances was 1% or more.

DEFRA replaces the stock issuance provision of prior law. Effective July 18, 1984, decreases in percentage holdings attributable to issuances of stock (or to issuances of stock coupled with redemptions of stock) are disregarded, provided:

(1) the decrease is due solely to such stock issuances and redemptions;

(2) the net percentage decrease is less than 2%; and

(3) the number of shares held by the foundation is not affected by such issuance or redemption. For these purposes, an increase in the number of shares held by the foundation resulting solely from a stock split applicable to all holders of the same class of stock is to be disregarded.

If this exception to the downward ratchet rule applies, then the maximum permitted holdings of the foundation will not be reduced. However, if the net percentage decrease exceeds 2%, then the exception does not apply and the permitted holdings will be reduced by the entire amount of the decrease.

(C) Aggregation of Stock Holdings of Private Foundation and Disqualified Persons for 95% Ownership Test

DEFRA modifies IRC 4943(c)(4)(B)(i) to provide that the 20-year first phase period to reduce pre-1969 excess business holdings applies if the combined holdings of the private foundation and disqualified persons exceeded 95% on May

26, 1969. Formerly the 20-year period applied only if the holdings of the foundation alone exceeded that amount. This amendment is effective retroactively to 1969.

(D) Five-Year Period to Dispose of Excess Holdings Resulting from Certain Acquisitions by Disqualified Persons

During the second or third phases of the IRC 4943 divestiture period for grandfathered holdings, a private foundation is permitted to hold at most 25% of the voting stock of a business enterprise if all disqualified persons together hold more than 2% of the voting stock of the business enterprise. However, if all disqualified persons together hold 2% or less of the voting stock, then the foundation is permitted to hold its grandfathered or other permitted level of voting stock (up to 50% during the second phase; up to 35% during the third phase on its own behalf; and up to 50% in the third phase in combination with disqualified persons).

Under prior law, if disqualified persons purchased enough voting stock to exceed 2% of the voting stock of a business enterprise during the second or third phase, a foundation with grandfathered holdings of more than 25% of the voting stock would thereupon be in violation of the second and third phase limitations, with only 90 days to reduce its excess holdings to the permitted 25% level. See Reg. 53.4943-2(a)(ii).

DEFRA provides an amendment to IRC 4943(c)(6) to allow foundations in the second and third phases five years to reduce their holdings to the 25% level in the event disqualified persons purchase enough stock to exceed the 2% level.

This provision went into effect July 18, 1984, for acquisitions made after that date.

(E) Employee Stock Ownership Plans Excepted from Definition of "Disqualified Person" for Purposes of IRC 4943(c)(4) and (5)

Only with respect to grandfathered holdings described in IRC 4943(c)(4) and (5), DEFRA provides that employee stock ownership plans (ESOP's) described in IRC 4975(e)(7) are not included within the term "disqualified person" as defined in IRC 4946(a).

6. Changes to IRC 4945 Expenditure Responsibility Rules

(A) Private Foundation Donors to Exempt Operating Foundations Described in IRC 4940(d)(2) Not Required to Exercise Expenditure Responsibility

Under prior law, grants by a private foundation to organizations other than those described in IRC 509(a)(1), (2), or (3), were considered taxable expenditures under IRC 4945(d)(4) unless the foundation exercised expenditure responsibility with respect to the grants.

Under DEFRA, where an exempt operating foundation (EOF) described in IRC 4940(d)(2) is the recipient of the grant, a private foundation donor does not need to exercise expenditure responsibility. This provision gives EOF's the same treatment as that of public charities in this respect. Private foundation donors to private operating foundations that are not EOF's must continue to exercise expenditure responsibility under the new law.

This provision applies to grants made after December 31, 1984.

(B) Treasury Department Directed to Modify Expenditure Responsibility Rules

Although no statutory change was made, the Conference Committee Report that accompanied H.R. 4170 directs the Treasury Department to review the expenditure responsibility requirements in the regulations underlying IRC 4945 to determine whether any of these requirements are unduly burdensome or unnecessary. As part of its review, the Treasury Department was specifically directed to modify the requirements for grantor reports to the IRS (Reg. 53.4945-5(d)). In requesting this review, Congress was concerned whether the existing regulations might operate to deter grants by some foundations to newly formed, community-based organizations.

Until these modifications are made, the existing provisions of these regulations will remain in effect.

7. Advance Ruling Period to be Extended for New Public Charities; Foundations to be Able to Place Greater Reliance on Classification of Donees as Public Charities

Under current law, a private foundation donor must exercise expenditure responsibility over grants made to organizations that are not public charities. Also, distributions to private nonoperating foundations normally may not be used to satisfy the donor foundation's minimum distribution requirements under IRC 4942. Consequently, it is important for a donor foundation to be able to rely on a recipient organization's classification as a public charity.

A donor foundation is permitted to rely on a determination by the IRS that an organization is a public charity unless notice has been published to the contrary, or the donor is responsible for or aware of a change in the recipient organization's sources of support that results in the loss of the recipient's public charity classification. A donor foundation will not be considered responsible for or aware of such a change in support, and may rely on a published classification, if the grant is made in reliance on a detailed written statement by the grantee organization that the grant will not result in the loss of its public charity classification. Reg. 1.509(a)-3(c)(1)(iii); Rev. Proc. 81-6, 1981-1 C.B. 620.

New organizations may have particular difficulty in obtaining sufficient public support to assure qualification as public charities. Because Congress was concerned that some private foundations may hesitate to make grants to newly formed organizations, the Conference Committee directed the Treasury Department to modify its rules to permit greater reliance on IRS classifications of newly formed organizations as public charities during the first five years of their existence.

Among the modifications to be made is an extension of the advance ruling period to five years for new public charities to demonstrate sufficient public support. Currently a new organization can obtain a five or six year advance ruling period only if it specifically requests an extended advance ruling in its application for exempt status. After existing regulations are modified, some form of five-year advance ruling period will apply to new organizations.

Until these modifications have been made, however, the current regulations and advance ruling period requirements will remain in effect.

8. Abatement of Private Foundation First Tier Taxes Where Reasonable Cause is Present

Before DEFRA, there was no "reasonable cause" exception to the imposition of the private foundation excise taxes. First tier taxes were applied automatically

when taxable events occurred. DEFRA allows an exception to the imposition of first-tier taxes, except for the IRC 4941(a) initial tax on acts of self-dealing, if it is established to the satisfaction of the Service that:

> (A) the event giving rise to the tax was due to reasonable cause;
>
> (B) the event giving rise to the tax was not due to willful neglect; and
>
> (C) a correction was made within the applicable correction period in the manner required to avoid the imposition of second-tier taxes.

For these purposes, a violation merely due to ignorance of the law does not qualify for abatement.

The exception is applicable to the initial taxes of IRC 4942(a), 4943(a), 4944(a), and 4945(a) for taxable events after December 31, 1984. It is not applicable to IRC 4941(a).

9. Public Disclosure Requirements for Private Foundations

(A) Annual Newspaper Notice to Include Telephone Number

Effective January 1, 1985, a private foundation must include the telephone number of its principal office in the annual newspaper notice now required by IRC 6104(d) announcing the availability for public inspection of the foundation's annual return (Form 990-PF). This change was made to assist grant applicants in locating grant-making foundations.

(B) IRS Directed to Enforce Annual Return Requirements

A 1983 General Accounting Office report criticized the IRS for not strictly enforcing the requirements that all information requested on Form 990-PF be provided. Some foundations were not fully completing the return. Congress directed the IRS to intensify its enforcement activities to ensure availability of this information.

10. Definition of Family Member in IRC 4946(d) Changed

IRC 4946(d), which defines family members for purposes of the definition of disqualified person of IRC 4946(a), is modified effective January 1, 1985, so that a member of the family does not include all lineal descendants and spouses of lineal descendants. Instead, the only lineal descendants (and spouses thereof) that now will be considered members of the family are children, grandchildren, and great grandchildren.

11. Person Ceases to Be a Substantial Contributor After 10 Years With No Connection with a Foundation

Before DEFRA, once a person attained the status of substantial contributor with respect to a private foundation, that person remained a substantial contributor at all times thereafter. IRC 507(d)(2)(B)(iv). The new law modifies this provision for taxable years beginning after December 31, 1984, by allowing an exception for persons who have had no connection with the foundation for at least 10 years.

Under new IRC 507(d)(2)(C), a person who has been a substantial contributor to a private foundation will cease to be a substantial contributor as of the close of any taxable year of the foundation, if:

(1) during the 10-year period ending at the close of the foundation's taxable year, the person and all related persons have not made any contributions to the foundation;

(2) at no time during the 10-year period was the person (or any related person) a foundation manager; and

(3) the aggregate contributions (adjusted for appreciation while held by the foundation) made by the person and all related persons are found by the Service to be insignificant when compared to the aggregate contributions made to the foundation by another contributor. The Committee Reports suggest that contributions from one individual will be considered insignificant if they are less than 1% of the aggregate contributions of another contributor.

Once a person ceases to be a substantial contributor to a foundation, persons who are disqualified persons solely because of their relationship to that person will cease to be disqualified persons.

For purposes of this provision, a "related person" includes any other person who would be a disqualified person by virtue of a relationship to that person. If the contributor is a corporation, officers or directors of the corporation are related persons.

MISCELLANEOUS PROVISIONS

12. Certain Child Care Organizations Considered "Educational" for Purposes or IRC 501(c)(3)

The IRS has allowed tax exemption under IRC 501(c)(3) to child care organizations where enrollment was based on financial need of the family and the need of the child for the program, or where the child care center provided pre-school age children of working parents with an educational program through a staff of qualified teachers. Rev. Rul. 68-166, 1968-1 C.B. 223; Rev. Rul. 70-533, 1970-2 C.B. 112. In addition, the Service has acquiesced in a court decision allowing exemption where a child care center was organized and operated for educational rather than custodial purposes. San Francisco Infant School, Inc. v. Commissioner, 69 T.C. 957 (1978), acq. 1978-2 C.B. 2.

The new legislation enacted IRC 501(k), which provides that child care organizations are considered educational for purposes of IRC 501(c)(3) when:

(1) the provision of care is away from the child's home;

(2) substantially all of the care provided is for the purpose of enabling individuals to be gainfully employed; and

(3) the services are available to the general public.

The effect of this provision is to relieve child care organizations of any need to show they provide educational activities or programs for the children in their care. The provision is effective for taxable years beginning after July 18, 1984.

13. Certain Educational Institutions Not Subject to Tax on Unrelated Debt-Financed Income From Real Property Acquisitions

IRC 514 subjects exempt organizations to tax under IRC 511 on unrelated income from debt-financed property. IRC 514(c)(9), as it existed before DEFRA, excepted from the application of this tax real property acquired by pension trusts described in IRC 401. However, IRC 514(c)(9)(B) listed a series of exceptions whereby a pension trust would be taxed under IRC 514 on its income from debt-financed real property.

DEFRA amends IRC 514(c)(9) to allow educational organizations described in IRC 170(b)(1)(A)(ii), as well as their affiliated supporting organizations described in IRC 509(a), the same exception from the application of IRC 514 that pension trusts enjoy for their real property acquisitions and improvements. The change is effective for acquisitions made after July 18, 1984.

The Act also makes some revisions to the exceptions of IRC 514(c)(9)(B), although most remain substantially unchanged. The most significant include:

(1) Organizations will not qualify for the exception to the application of IRC 514 where the seller, or a disqualified person described in IRC 4975(e)(2)(F) or (H), provides any part of the financing of the acquisition or improvement. Prior to DEFRA, only nonrecourse financing by the seller or disqualified person was prohibited.

(2) With DEFRA, the protection of IRC 514(c)(9) does not apply if the real property is held by a partnership, unless the partnership itself is not subject to the exceptions of IRC 514(c)(9)(B) and unless

(a) all partners are either pension trusts or educational institutions (or their supporting affiliates); or

(b) each allocation to a partner is a qualified allocation under IRC 168(j)(9). Generally, this means that the tax-exempt partner is allocated the same percentage share of each

item of partnership income, gain, loss, deduction, or credit, and basis; the percentage share remains the same as long as the tax-exempt organization remains a partner; and the allocation has a substantial economic effect as determined under partnership allocation rules. (See IRC 704(b)(2)).

14. Gambling Conducted by a Nonprofit Organization is Not Unrelated Trade or Business in Certain Cases

Although DEFRA makes no change to the statute, it states that for purposes of IRC 513 the term "unrelated trade or business" does not include a trade or business that consists of conducting a game of chance if

(1) the game of chance is conducted by a nonprofit organization;

(2) the conducting of the game by the organization does not violate any state or local law; and

(3) as of October 5, 1983, there was a state law in effect that permitted the conducting of the game of chance only by a nonprofit organization.

The provision is effective for games of chance conducted after June 30, 1981.

The provision goes beyond IRC 513(f), which provides that bingo games that are not ordinarily carried out on a commercial basis, and that do not violate state or local law, are not unrelated trade or business. If a state law that was in effect on October 5, 1983, permits the particular game of chance only by nonprofit organizations, and state or local law are not otherwise violated, DEFRA allows other gambling activities in addition to bingo to be conducted by a nonprofit organization without being considered unrelated trade or business. Where the new law applies, it would appear that organizations would be relieved from strict compliance with the provisions of IRC 513(f)(2)(A) and (B) governing the conduct of bingo games.

It is unclear how many jurisdictions are affected by this provision, but it was clearly intended to apply in North Dakota. It is possible that application will vary among localities within a state if the state permits local option to legalize gambling by nonprofit organizations.

15. IRC 501(c)(1) Revised

Prior to DEFRA, an organization was exempt under IRC 501(c)(1) if it was an instrumentality of the United States that was organized under Act of Congress and was specifically granted tax exemption in the organizing act.

With DEFRA, the grant of tax exemption to an organization in its authorizing legislation is no longer sufficient for IRC 501(c)(1) status. Unless an organization was exempt under its organizing act, as amended and supplemented, before July 18, 1984, it can only qualify for IRC 501(c)(1) exemption if the exemption is specifically provided for in the Internal Revenue Code. Thus, all new IRC 501(c)(1) organizations must now be referred to by name as exempt within the Code.

The first, and so far the only, organization to qualify for exemption under this new procedure is the Central Liquidity Facility, which is granted exemption in new IRC 501(1).

16. Deductibility of Contributions to Indian Tribal Governments Made Permanent

IRC 7871 has allowed, for years 1983 and 1984 only, Indian tribal governments to be treated as states for certain purposes, including deductibility of contributions under IRC 170. The new legislation makes permanent the deductibility provisions of IRC 7871. The legislation also clarifies the status of Indian tribal governments as public charities.

17. One-Time Election to Remove Church Employees from FICA Coverage

Under the 1983 amendments to the Social Security Act, nonprofit organizations (including religious organizations) are subject to mandatory social security (FICA) coverage. Ministers and members of religious orders are exempted from this requirement.

DEFRA allows a one-time only irrevocable election by a church or qualifying church controlled organization to exclude from FICA coverage all

services performed for the organization, except services in an unrelated trade or business. However, employees of electing organizations will be subject to self-employment (SECA) taxes for the excluded services whenever wages earned are $100 or more for the calendar year.

Elections for churches and church controlled organizations that were organized before October 1, 1984, had to be filed before October 30, 1984. An organization established at a later date, or an already established church that hires its first employee at a later date, must file by the day before the due date of the electing organization's quarterly employment tax return. Form 8274 is used for this purpose. See Announcement 84-95, 1984-40 I.R.B. 16. Elections filed after these dates are void.

To make an election, an organization must state that it is opposed for religious reasons to payment of social security taxes. Once an election is made, it is irrevocable by the organization. It may, however, be revoked by the IRS for continuing failure to provide required reports under IRC 6051, such as W-2 Forms.

An election is available to

(1) churches, including conventions and associations of churches;

(2) elementary or secondary schools controlled or principally supported by churches, or by conventions or associations of churches; and

(3) church controlled tax-exempt organizations described in IRC 501(c)(3). However, in this category election is not available to organizations that

(a) offer goods, services, or facilities for sale on more than an incidental basis to the general public, other than at a nominal charge which is substantially less than cost; and

(b) normally receive more than 25% of their support from government sources or receipts from sales or services from activities that are not an unrelated trade or business.

The provision is effective for services performed on or after January 1, 1984.

18. Reporting Requirements for Donors and Donees of Large Gifts of Property

(A) The Donor

For contributions made after December 31, 1984, a donor must include a qualified appraisal for gifts of real or personal property (other than publicly traded securities) for which a deduction is taken under IRC 170, if the claimed value of the property (plus the claimed value of all similar items of property to one or more donees) exceeds $5000.

The appraisal must be performed by a qualified appraiser, who cannot be the taxpayer, the donee, a party to the transaction in which the taxpayer acquired the property, an employee of any of the above, or any person whose relationship with the taxpayer would cause a reasonable person to question the independence of the appraiser.

An appraisal summary must be prepared for any gift covered by this provision. This summary must be acknowledged by the donee and attached to the taxpayer's return along with information showing the taxpayer's cost basis and acquisition date of the property.

Congress did not enact these provisions as part of the Internal Revenue Code, but directed the Treasury Department to adopt and expand upon them through regulations.

(B) The Donee

If within 2 years of receipt from the donor, a donee sells, exchanges, or otherwise disposes of property for which a qualified appraisal was required by the donor under the above provisions, the donee must file a return with the IRS setting forth specified details of the transaction, and must furnish a copy of the return to the donor. IRC 6050L.