DESCRIPTION OF THE CHAIRMAN'S AMENDMENT IN THE NATURE OF A SUBSTITUTE TO H.R. 7, THE "CHARITABLE GIVING ACT OF 2003"

Scheduled for Markup
By the
COMMITTEE ON WAYS AND MEANS
on September 9, 2003

Prepared by the Staff
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JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The House Committee on Ways and Means has scheduled a markup of H.R. 7, the "Charitable Giving Act of 2003" for September 9, 2003. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the Chairman's amendment in the nature of a substitute to H.R. 7.

[1] This document may be cited as follows: Joint Committee on Taxation, *Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 7, the "Charitable Giving Act of 2003"* (JCX-73-03), September 8, 2003.

I. CHARITABLE GIVING INCENTIVES

A. Charitable Deduction for Nonitemizers

Present Law

An individual taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and up to the fair market value of property contributed to a charity described in section 501(c)(3),[2] to certain veterans' organizations, fraternal societies, and cemetery companies,[3] or to a Federal, State, or local governmental entity for exclusively public purposes.[4] The deduction also is allowed for purposes of calculating alternative minimum taxable income.

The amount of the charitable deduction allowable for a taxable year with respect to a contribution of property may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.[5]

A taxpayer who takes the standard deduction (i.e., who does not itemize deductions) may not take a separate deduction for charitable contributions.[6]

A payment to a charity (regardless of whether it is termed a "contribution") in exchange for which the donor receives an economic benefit is not deductible, except to the extent that the donor can demonstrate that the payment exceeds the fair market value of the benefit received from the charity. To facilitate distinguishing charitable contributions from purchases of goods or services from charities, present law provides that no charitable contribution deduction is allowed for a separate contribution of $250 or more unless the donor obtains a contemporaneous written acknowledgement of the contribution from the charity indicating whether the charity provided any good or service (and an estimate of the value of any such good or service) to the taxpayer in consideration for the contribution.[7] In addition, present law requires that any charity that receives a contribution exceeding $75 made partly as a gift and partly as consideration for goods

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[2] All section references are to the Internal Revenue Code of 1986, unless otherwise indicated.

[3] Secs. 170(c)(3)-(5).

[4] Sec. 170(c)(1).

[5] Secs. 170(b) and (e).

[6] Sec. 170(a). The Economic Recovery Tax Act of 1981 adopted a temporary provision that permitted individual taxpayers who did not itemize income tax deductions to claim a deduction from gross income for a specified percentage of their charitable contributions. The maximum deduction was $25 for 1982 and 1983, $75 for 1984, 50 percent of the amount of the contribution for 1985, and 100 percent of the amount of the contribution for 1986. The nonitemizer deduction terminated for contributions made after 1986.

[7] Sec. 170(f)(8).

or services furnished by the charity (a "quid pro quo" contribution) is required to inform the contributor in writing of an estimate of the value of the goods or services furnished by the charity and that only the portion exceeding the value of the goods or services is deductible as a charitable contribution.[8]

Description of Proposal

In the case of an individual taxpayer who does not itemize deductions, the proposal allows a "direct charitable deduction" from adjusted gross income for charitable contributions paid in cash during the taxable year. This deduction is allowed in addition to the standard deduction. The deduction is allowed only for that portion of contributions actually made during the year that in the aggregate exceed $250 ($500 in the case of a joint return). The maximum deduction is $250 ($500 in the case of a joint return). Thus, under the proposal, an individual who does not file a joint return is not entitled to a charitable deduction for the first $250 of cash contributions made during the tax year, is entitled to a deduction on a dollar-for-dollar basis for contributions of $251 to $500 (e.g., a $1 contribution deduction in the case of $251 of contributions, and a $250 deduction in the case of $500 of contributions), and is not entitled to a deduction for contributions exceeding $500. Contributions may not be carried over for purposes of a subsequent taxable year's calculation of the direct charitable deduction.[9]

The direct charitable deduction generally is subject to the tax rules normally governing charitable contribution deductions, such as the substantiation requirements. The deduction is allowed in computing alternative minimum taxable income.

The proposal requires the Secretary of the Treasury to complete a study by December 31, 2006, of the effect of the proposal on increased charitable giving, and of taxpayer compliance, for example, by comparing compliance by taxpayers who itemize their charitable contributions with compliance by those who claim the direct charitable deduction. The Secretary shall report on the study to the Committee on Finance of the Senate and the Committee on Ways and Means of the House of Representatives.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2003, and before January 1, 2006.

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[8] Sec. 6115.

[9] The proposal does not alter present-law rules regarding the carryover of contributions to or from a taxable year, including a taxable year in which the taxpayer elects the standard deduction.

B. Tax-Free Distributions From IRAs for Charitable Purposes

Present Law

In general

If an amount withdrawn from a traditional individual retirement arrangement ("IRA") or a Roth IRA is donated to a charitable organization, the rules relating to the tax treatment of withdrawals from IRAs apply to the amount withdrawn and the charitable contribution is subject to the normally applicable limitations on deductibility of such contributions.

Charitable contributions

In computing taxable income, an individual taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and up to the fair market value of property contributed to a charity described in section 501(c)(3), to certain veterans' organizations, fraternal societies, and cemetery companies,[10] or to a Federal, State, or local governmental entity for exclusively public purposes.[11] The deduction also is allowed for purposes of calculating alternative minimum taxable income.

The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.[12]

Under present law, total deductible contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer's contribution base, which is the taxpayer's adjusted gross income for a taxable year (disregarding any net operating loss carryback). Contributions of capital gain property to public charities, and contributions of cash to private foundations and certain other charitable organizations, generally may be deducted up to 30 percent of the taxpayer's contribution base. Contributions of capital gain property to private foundations and certain other charitable organizations generally may be deducted up to 20 percent of the taxpayer's contribution base.

Contributions by individuals in excess of the 50-percent, 30-percent, and 20-percent limit may be carried over and deducted over the next five taxable years, subject to the relevant percentage limitations on the deduction in each of those years.

In addition to the percentage limitations imposed specifically on charitable contributions, present law imposes a reduction on most itemized deductions, including charitable contribution

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[10] Secs. 170(c)(3)-(5).

[11] Sec. 170(c)(1).

[12] Secs. 170(b) and (e).

deductions, for taxpayers with adjusted gross income in excess of a threshold amount, which is indexed annually for inflation. The threshold amount for 2003 is $139,500 ($69,750 for married individuals filing separate returns). For those deductions that are subject to the limit, the total amount of itemized deductions is reduced by three percent of adjusted gross income over the threshold amount, but not by more than 80 percent of itemized deductions subject to the limit. Beginning in 2006, the overall limitation on itemized deductions phases-out for all taxpayers. The overall limitation on itemized deductions is reduced by one-third in taxable years beginning in 2006 and 2007, and by two-thirds in taxable years beginning in 2008 and 2009. The overall limitation on itemized deductions is eliminated for taxable years beginning after December 31, 2009; however, this elimination of the limitation sunsets on December 31, 2010.

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity (e.g., a remainder) while also either retaining an interest in that property (e.g., an income interest) or transferring an interest in that property to a noncharity for less than full and adequate consideration.[13] Exceptions to this general rule are provided for, among other interests, remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, and present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property.[14] For such interests, a charitable deduction is allowed to the extent of the present value of the interest transferred to a charitable organization.

IRA rules

Within limits, individuals may make deductible and nondeductible contributions to a traditional IRA. Amounts in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal represents a return of nondeductible contributions). Individuals also may make nondeductible contributions to a Roth IRA. Qualified withdrawals from a Roth IRA are excludable from gross income. Withdrawals from a Roth IRA that are not qualified withdrawals are includible in gross income to the extent attributable to earnings. Includible amounts withdrawn from a traditional IRA or a Roth IRA before attainment of age 59-1/2 are subject to an additional 10-percent early withdrawal tax, unless an exception applies. Under present law, minimum distributions are required to be made from tax-favored retirement vehicles, including IRAs. In general, minimum required distributions must begin by the April 1 of the calendar year following the year in which the IRA owner attains age 70-1/2.

If an individual has made nondeductible contributions to a traditional IRA, a portion of each distribution from an IRA is nontaxable, until the total amount of nondeductible contributions has been received. In general, the amount of a distribution that is nontaxable is determined by multiplying the amount of the distribution by the ratio of the remaining nondeductible contributions to the account balance. In making the calculation, all traditional IRAs of an individual are treated as a single IRA, all distributions during any taxable year are

[13] Secs. 170(f), 2055(e)(2), and 2522(c)(2).

[14] Sec. 170(f)(2).

treated as a single distribution, and the value of the contract, income on the contract, and investment in the contract are computed as of the close of the calendar year.

In the case of a distribution from a Roth IRA that is not a qualified distribution, in determining the portion of the distribution attributable to earnings, contributions and distributions are deemed to be distributed in the following order: (1) regular Roth IRA contributions; (2) taxable conversion contributions;[15] (3) nontaxable conversion contributions; and (4) earnings. In determining the amount of taxable distributions from a Roth IRA, all Roth IRA distributions in the same taxable year are treated as a single distribution, all regular Roth IRA contributions for a year are treated as a single contribution, and all conversion contributions during the year are treated as a single contribution.

Split-interest trust filing requirements

Split-interest trusts, including charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, are required to file an annual information return[16] (Form 1041-A). Trusts that are not split-interest trusts but that claim a charitable deduction for amounts permanently set aside for a charitable purpose also are required to file Form 1041-A.[17] The returns are required to be made publicly available.[18] A trust that is required to distribute all trust net income currently to trust beneficiaries in a taxable year is exempt from this return requirement for such taxable year. A failure to file the required return may result in a penalty on the trust of $10 a day for as long as the failure continues, up to a maximum of $5,000 per return.

In addition, split-interest trusts are required to file annually Form 5227.[19] Form 5227 requires disclosure of information regarding a trust's noncharitable beneficiaries. The penalty for failure to file this return is calculated based on the amount of tax owed. A split-interest trust generally is not subject to tax and therefore, a penalty generally may not be imposed for the failure to file Form 5227. Form 5227 is not required to be made publicly available.

Description of Proposal

Qualified charitable distributions from IRAs

[15] Conversion contributions refer to conversions of amounts in a traditional IRA to a Roth IRA.

[16] Sec. 6034. This requirement applies to all split-interest trusts described in section 4947(a)(2).

[17] Secs. 642(c) and 6034.

[18] Sec. 6104(b).

[19] Sec. 6011; Treas. Reg. sec. 53.6011-1(d).

The proposal provides an exclusion from gross income for otherwise taxable IRA distributions from a traditional or a Roth IRA in the case of qualified charitable distributions.[20] Special rules apply in determining the amount of an IRA distribution that is otherwise taxable. The present-law rules regarding taxation of IRA distributions and the deduction of charitable contributions continue to apply to distributions from an IRA that are not qualified charitable distributions. Qualified charitable distributions are taken into account for purposes of the minimum distribution rules applicable to IRAs to the same extent the distribution would have been taken into account under such rules had the distribution not been directly distributed under the provision. An IRA does not fail to qualify as an IRA merely because qualified charitable distributions have been made from the IRA.

A qualified charitable distribution is defined as any distribution from an IRA that is made directly by the IRA trustee either to (1) an organization to which deductible contributions can be made (a "direct distribution") or (2) a "split-interest entity." A split-interest entity means a charitable remainder annuity trust or charitable remainder unitrust (together referred to as a "charitable remainder trust"), a pooled income fund, or a charitable gift annuity. Distributions are eligible for the exclusion only if made on or after the date the IRA owner attains age 70-1/2, to correspond with the time at which minimum distributions must begin. In the case of split-interest distributions, no person may hold an income interest in the amounts in the split-interest entity attributable to the charitable distribution other than the IRA owner, the IRA owner's spouse, or a charitable organization.

The exclusion applies to direct distributions only if a charitable contribution deduction for the entire distribution otherwise would be allowable, determined without regard to the generally applicable percentage limitations. Thus, for example, if the deductible amount is reduced because of a benefit received in exchange, or if a deduction is not allowable because the donor did not obtain sufficient substantiation, the exclusion is not available with respect to any part of the IRA distribution. Similarly, the exclusion applies in the case of a distribution directly to a split-interest entity only if a charitable contribution deduction for the entire present value of the charitable interest (for example, a remainder interest) otherwise would be allowable, determined without regard to the generally applicable percentage limitations.

If the IRA owner has any IRA that includes nondeductible contributions, a special rule applies in determining the portion of a distribution that is includible in gross income (but for the proposal) and thus is eligible for qualified charitable distribution treatment. In such case, the IRA owner aggregates all IRAs to determine eligibility for the exclusion. Under the special rule, the distribution is treated as consisting of income first, up to the aggregate amount that would be includible in gross income (but for the proposal) if the aggregate balance of all IRAs having the same owners were distributed during the same year. In determining the amount of subsequent IRA distributions includible in income, proper adjustments are made to reflect the amount treated as a qualified charitable distribution under the special rule.

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[20] The proposal does not apply to distributions from employer sponsored retirement plans, including SIMPLE IRAs and simplified employee pensions ("SEPs").

Special rules apply for distributions to split-interest entities. For distributions to charitable remainder trusts, the proposal provides that subsequent distributions from the charitable remainder trust are treated as ordinary income in the hands of the beneficiary, notwithstanding how such amounts normally are treated under section 664(b). In addition, for a charitable remainder trust to be eligible to receive qualified charitable distributions, the charitable remainder trust has to be funded exclusively by such distributions. For example, an IRA owner may not make qualified charitable distributions to an existing charitable remainder trust any part of which was funded with assets that were not qualified charitable distributions.

Under the proposal, a pooled income fund is eligible to receive qualified charitable distributions only if the fund accounts separately for amounts attributable to such distributions. In addition, all distributions from the pooled income fund that are attributable to qualified charitable distributions are treated as ordinary income to the beneficiary. Qualified charitable distributions to a pooled income fund are not includible in the fund's gross income.

In determining the amount includible in gross income by reason of a payment from a charitable gift annuity purchased with a qualified charitable distribution from an IRA, the portion of the distribution from the IRA used to purchase the annuity is not an investment in the annuity contract.

Any amount excluded from gross income by reason of the proposal is not taken into account in determining the deduction for charitable contributions under section 170.

Qualified charitable distribution examples

The following examples illustrate the determination of the portion of an IRA distribution that is a qualified charitable distribution and the application of the special rules for a qualified charitable distribution to a split-interest entity. In each example, it is assumed that the requirements for qualified charitable distribution treatment are otherwise met (e.g., the applicable age requirement and the requirement that contributions are otherwise deductible) and that no other IRA distributions occur during the year.

Example 1.–Individual A has a traditional IRA with a balance of $100,000, consisting solely of deductible contributions and earnings. Individual A has no other IRA. The entire IRA balance is distributed in a direct distribution to a charitable organization. Under present law, the entire distribution of $100,000 would be includible in Individual A's income. Accordingly, under the proposal, the entire distribution of $100,000 is a qualified charitable distribution. As a result, no amount is included in Individual A's income as a result of the distribution and the distribution is not taken into account in determining the amount of Individual A's charitable deduction for the year.

Example 2.–The facts are the same as in Example 1, except that the entire IRA balance of $100,000 is distributed to a charitable remainder unitrust, which contains no other assets and which must be funded exclusively by qualified charitable distributions. Under the terms of the trust, Individual A is entitled to receive five percent of the value of the trust each year. As explained in Example l, the entire $100,000 distribution is a qualified charitable distribution, no amount is included in Individual A's income as a result of the distribution, and the distribution is

not taken into account in determining the amount of Individual A's charitable deduction for the year. In addition, under a special rule in the proposal for charitable remainder trusts, any distribution from the charitable remainder unitrust to Individual A is includible in gross income as ordinary income, regardless of the character of the distribution under the usual rules for the taxation of distributions from such a trust.

Example 3.–Individual B has a traditional IRA with a balance of $100,000, consisting of $20,000 of nondeductible contributions and $80,000 of deductible contributions and earnings. Individual B has no other IRA. In a direct distribution to a charitable organization, $80,000 is distributed from the IRA. Under present law, a portion of the distribution from the IRA would be treated as a nontaxable return of nondeductible contributions. The nontaxable portion of the distribution would be $16,000, determined by multiplying the amount of the distribution ($80,000) by the ratio of the nondeductible contributions to the account balance ($20,000/$100,000). Accordingly, under present law, $64,000 of the distribution ($80,000 minus $16,000) would be includible in Individual B's income.

Under the proposal, notwithstanding the present-law tax treatment of IRA distributions, the distribution is treated as consisting of income first, up to the total amount that would be includible in gross income (but for the proposal) if all amounts were distributed from all IRAs otherwise taken into account in determining the amount of IRA distributions. The total amount that would be includible in income if all amounts were distributed from the IRA is $80,000. Accordingly, under the proposal, the entire $80,000 distributed to the charitable organization is treated as includible in income (before application of the proposal) and is a qualified charitable distribution. As a result, no amount is included in Individual B's income as a result of the distribution and the distribution is not taken into account in determining the amount of Individual B's charitable deduction for the year. In addition, for purposes of determining the tax treatment of other distributions from the IRA, $20,000 of the amount remaining in the IRA is treated as Individual B's nondeductible contributions (i.e., not subject to tax upon distribution).

Split-interest trust filing requirements

The proposal increases the penalty on split-interest trusts for failure to: (1) file a return; (2) include any of the information required to be shown on such return; and (3) show the correct information on the return. The penalty for each return is $20 for each day the failure continues up to a maximum of $10,000. In the case of a split-interest trust with gross income in excess of $250,000, the penalty is $100 for each day the failure continues up to a maximum of $50,000. In addition, if a person (meaning any officer, director, trustee, employee, or other individual who is under a duty to file the return or include required information)[21] knowingly failed to file the return or include required information, then that person is personally liable for such a penalty, which would be imposed in addition to the penalty that is paid by the organization. Information regarding beneficiaries that are not charitable organizations as described in section 170(c) is exempt from the requirement to make information publicly available. In addition, the proposal repeals the present-law exception to the filing requirement for split-interest trusts that are required in a taxable year to distribute all net income currently to beneficiaries. Such exception

[21] Sec. 6652(c)(4)(C).

remains available to trusts other than split-interest trusts that are otherwise subject to the filing requirement.

Effective Date

The qualified charitable distribution proposal is effective for distributions made after December 31, 2003. The proposal relating to information returns of split-interest trusts is effective for returns for taxable years beginning after December 31, 2003.

C. Increase Percentage Limitation for Corporate Charitable Contributions

Present Law

Under present law, a corporation is allowed to deduct charitable contributions up to 10 percent of the corporation's modified taxable income for the year. For this purpose, taxable income is determined without regard to (1) the charitable contributions deduction, (2) any net operating loss carryback, (3) deductions for dividends received, and (4) any capital loss carryback for the taxable year.[22] Any charitable contribution by a corporation that is not currently deductible because of the percentage limitation may be carried forward for up to five taxable years.

Description of Proposal

The proposal increases the percentage limitation on corporate charitable deductions from 10 percent to 20 percent. The proposal is phased-in, beginning in taxable years beginning after December 31, 2003. The percentage limitation on corporate charitable deductions is determined in accordance with the following table:

Taxable years beginning in calendar year	Applicable percentage
2004	11
2005	12
2006	13
2007	14
2008 through 2011	15
2012 and thereafter	20

Effective Date

The proposal is effective for taxable years beginning after December 31, 2003.

[22] Sec. 170(b)(2).

D. Charitable Deduction for Contributions of Food Inventory

Present Law

Under present law, a taxpayer's deduction for charitable contributions of inventory generally is limited to the taxpayer's basis (typically, cost) in the inventory.

However, for certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciated value (i.e., basis plus one half of fair market value in excess of basis) or (2) two times basis.[23] To be eligible for the enhanced deduction, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in section 501(c)(3) (except for private nonoperating foundations), and the donee must (1) use the property consistent with the donee's exempt purpose and solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements. In the case of contributed property subject to the Federal Food, Drug, and Cosmetic Act, the property must satisfy the applicable requirements of such Act on the date of transfer and for 180 days prior to the transfer. To use the enhanced deduction, the taxpayer must establish that the fair market value of the donated item exceeds basis.

Description of Proposal

Under the proposal, any taxpayer, whether or not a C corporation, engaged in a trade or business is eligible to claim an enhanced deduction for donations of food inventory. Under the proposal, an enhanced deduction for food inventory is available only for food that qualifies as "apparently wholesome food." For taxpayers other than C corporations, the total deduction for donations of food inventory in a taxable year generally may not exceed the applicable percentage of the taxpayer's aggregate net income for such taxable year from all sole proprietorships, S corporations, or partnerships from which contributions of apparently wholesome food are made. The applicable percentage equals the percentage limitation on corporate charitable contributions.[24] For example, assuming an applicable percentage of 11 percent, a taxpayer who is a sole proprietor, a shareholder in an S corporation, and a partner in a partnership, and who makes charitable contributions of food inventory from each, the taxpayer's deduction for donations of food inventory is limited to 11 percent of the taxpayer's net income from the sole proprietorship and the taxpayer's interests in the S corporation and partnership. However, if only the sole proprietorship and the S corporation made charitable contributions of food inventory, the

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[23] Sec. 170(e)(3). In general, a C corporation's charitable contribution deduction for a year may not exceed 10 percent of the corporation's taxable income. Sec. 170(b)(2).

[24] Under a separate proposal, the applicable percentage is 11 percent for taxable years beginning in 2004, 12 percent for taxable years beginning in 2005, 13 percent for taxable years beginning in 2006, 14 percent for taxable years beginning in 2007, 15 percent for taxable years beginning in 2008 through 2011, and 20 percent for taxable years beginning in 2012 and thereafter.

taxpayer's deduction would be limited to 11 percent of the net income of the sole proprietorship and the S corporation, but not the partnership.

The percentage limitation does not affect the application of the generally applicable percentage limitations. For example, if the applicable percentage is 11 percent, and 11 percent of a sole proprietor's net income from the sole proprietorship was greater than 50 percent of the proprietor's contribution base, the available deduction for the taxable year (with respect to contributions to public charities) would be 50 percent of the proprietor's contribution base. Consistent with present law, such contributions may be carried forward because they exceed the 50 percent limitation. Contributions of food inventory by a taxpayer that is not a C corporation that exceed the applicable percentage but not the 50 percent limitation could not be carried forward.

"Apparently wholesome food" is defined as food intended for human consumption that meets all quality and labeling standards imposed by Federal, State, and local laws and regulations even though the food may not be readily marketable due to appearance, age, freshness, grade, size, surplus, or other conditions.

The proposal provides that the fair market value of donated apparently wholesome food that cannot or will not be sold solely due to internal standards of the taxpayer or lack of market is determined by taking into account the price at which the same or substantially the same food items (as to both type and quality) are sold by the taxpayer at the time of the contribution or, if not so sold at such time, in the recent past.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2003.

E. Reform of Excise Tax Based on Net Investment Income of Private Foundations

Present Law

In general

In general, a private foundation is an organization organized and operated exclusively for charitable purposes.[25] Private foundations that are recognized as exempt from Federal income tax under section 501(a) of the Code are subject to a two-percent excise tax on their net investment income.[26] Private foundations that are not exempt from tax, such as certain charitable trusts, also are subject to an excise tax.[27]

The two-percent rate of tax is reduced to one-percent if certain requirements are met in a taxable year.[28] The requirements are that the foundation must make a certain minimum amount of qualifying distributions (generally, amounts paid to accomplish exempt purposes)[29] and the foundation cannot have been subject to tax for failure to make sufficient qualifying distributions for any of the five years preceding the taxable year (the "base period"). The required amount of qualifying distributions is the sum of two elements: (1) the amount of the foundation's assets for the taxable year multiplied by the average over the base period of the percentage of assets distributed as qualifying distributions in a year divided by the assets of the foundation for the year (the "average percentage payout for the base period") plus (2) one percent of the net investment income of the foundation for the taxable year.[30]

The tax on taxable private foundations is equal to the excess of the sum of the excise tax that would have been imposed if the foundation were tax exempt and the amount of the unrelated

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[25] Secs. 509(a) and 501(c)(3).

[26] Sec. 4940(a). Net investment income is determined under the principles of Subtitle A of the Code, except to the extent those principles are inconsistent with section 4940. Net investment income is defined as the amount by which the sum of gross investment income and capital gain net income exceeds the deductions relating to the production of gross investment income. Net investment income also is determined by applying section 103 (generally providing an exclusion for interest on certain State and local bonds) and section 265 (generally disallowing the deduction for interest and certain other expenses with respect to tax-exempt income). Special definitions of gross investment income and capital gain net income are provided for purposes of the excise tax. Sec. 4940(c).

[27] Secs. 4940(b) and 4947.

[28] Sec. 4940(e).

[29] Sec. 4942(g).

[30] Sec. 4940(e).

business income tax that would have been imposed if the foundation were tax exempt, over the income tax imposed on the foundation under subtitle A of the Code.

Private foundations (taxable and tax exempt) are required to pay estimated taxes of the section 4940 tax in quarterly installments in the same manner as corporate estimated tax payments.[31] Exempt operating foundations are exempt from the section 4940 tax.[32]

The amount of tax paid under section 4940 reduces a foundation's distributable amount under section 4942.[33] Accordingly, the minimum amount of qualifying distributions a foundation must make to avoid tax under section 4942 is reduced by the amount of section 4940 excise taxes paid.

Description of Proposal

The proposal replaces the two rates of tax under present law with a single rate of tax based on net investment income and establishes such rate of tax at one percent. Thus, a tax-exempt private foundation is subject to tax on one percent of net investment income and does not have to calculate its average percentage payout for the base period to determine eligibility for a different rate of tax. A taxable private foundation is subject to tax on the excess of the sum of one percent of net investment income and the amount of the unrelated business income tax (both calculated as if the foundation were tax-exempt) over the income tax imposed on the foundation under subtitle A of the Code.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2003.

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[31] Treas. Reg. sec. 1.6302-1.

[32] Sec. 4940(d)(1). To be an exempt operating foundation, an organization must (1) be an operating foundation (as defined in section 4942(j)(3)), (2) be publicly supported for at least 10 taxable years, (3) have a governing body no more than 25 percent of whom are disqualified persons and that is broadly representative of the general public, and (4) have no officers who are disqualified persons. Sec. 4940(d)(2). Exempt operating foundations generally include organizations such as museums or libraries that devote their assets to operating charitable programs but have difficulty meeting the "public support" tests necessary not to be classified as a private foundation. For an organization to qualify as an exempt operating foundation it must obtain a ruling letter from the IRS. IRS Announcement 85-88.

[33] Sec. 4942(d)(2).

F. Reform of Excise Taxes for Minimum Payout and Self Dealing

Present Law

Private nonoperating foundations

Private nonoperating foundations are required to pay out a minimum amount each year as qualifying distributions. Failure to pay out the minimum results in an excise tax of up to 100 percent of the undistributed amount.[34] In general, a qualifying distribution means any amount paid to accomplish one or more of the organization's exempt purposes, including that portion of reasonable and necessary administrative expenses.[35] Thus, under present law, a foundation may include as a qualifying distribution the salaries, occupancy expenses, travel costs, and other reasonable and necessary administrative expenses that the foundation incurs in operating a grant program. A qualifying distribution also includes any amount paid to acquire an asset used (or held for use) directly in carrying out one or more of the organization's exempt purposes and certain amounts set-aside for exempt purposes.[36]

Private operating foundations

Private operating foundations are not subject to the payout requirements. However, private operating foundations use the definition of a qualifying distribution in order to meet the "income test," pursuant to which a foundation qualifies as an operating foundation. The income test requires that a certain portion of the foundation's qualifying distributions (defined the same as for non operating foundations) must be made directly for the active conduct of the activities constituting the purpose or function for which the organization is organized and operated,[37] i.e., for a "direct charitable activity." For this purpose, a direct charitable activity means the active conduct of an activity constituting the organization's charitable, educational, or other similar exempt purpose, and does not include the making of grants to other organizations to assist such

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[34] Sec. 4942(a) and (b).

[35] Sec. 4942(g)(1)(A).

[36] Sec. 4942(g)(1)(B) and 4942(g)(2). In general, an organization is permitted to adjust the distributable amount in those cases where distributions during the five preceding years have exceeded the payout requirements. Sec. 4942(i).

[37] Sec. 4942(j)(3)(A). The Treasury regulations use slightly different words from that of the Code, and describe when distributions are made "directly for the active conduct of the activities constituting its charitable, educational or similar exempt purpose." Treas. Reg. sec. 53.4942(b)-1(b)(1). The instructions to IRS Form 990-PF use the term "direct charitable activity" to implement, for reporting purposes, the provisions of the Code and regulations.

organizations in conducting activities that help to accomplish the exempt purposes of the grantee organization.[38]

Conduit foundations

Private foundations described in section 170(b)(1)(E)(ii) (sometimes referred to as "conduit foundations") must make each year, in general, qualifying distributions equal to the amount of contributions received. Non corporate donors to a conduit foundation are subject to more favorable percentage limitations for charitable contributions than are non corporate donors to a non operating foundation that is not a conduit foundation.[39] A foundation that qualifies as a conduit foundation may elect each year to be treated as a conduit foundation.

Self-dealing

Excise taxes are imposed on acts of self-dealing between a disqualified person (as defined in section 4946(a)) and a private foundation.[40] An initial tax of 5 percent of the amount involved with respect to the act of self-dealing is imposed on any disqualified person (other than a foundation manager acting only as such) who participates in the act of self-dealing. The tax is imposed for each year in the taxable period, which begins on the date the act of self-dealing occurs and ends on the earliest of the date of mailing of a notice of deficiency for the tax, the date on which the tax is assessed, or the date on which correction of the act of self-dealing is completed. A government official (as defined in section 4946(c)) is subject to such initial tax only if the official participates in the act of self-dealing knowing it is such an act.

Description of Proposal

Modification of excise tax on failure to distribute income

The proposal modifies the definition of qualifying distributions of private foundations, including non operating foundations and conduit foundations, by excluding certain administrative expenses. The proposal does not alter the treatment of qualifying distributions made by private operating foundations, or change the meaning of qualifying distributions with respect to amounts paid to acquire an asset used (or held for use) directly in carrying out one or

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[38] This is the case regardless of whether the exempt activities of the grantee organization may assist the grantor foundation in carrying out its own exempt activities. Treas. Reg. 53.4942(b)-1(b)(1)(1).

[39] A charitable contribution by an individual to a private non operating foundation that is not a conduit foundation is subject to a limitation of 30 percent of the donor's contribution base for the taxable year; whereas, a charitable contribution by an individual to a conduit foundation is subject to a limitation of 50 percent of the donor's contribution base for the taxable year. Secs. 170(b)(1)(B) and 170(b)(1)(A)(vii). Contributions by a corporation are subject to a 10 percent of modified taxable income limitation, irrespective of the classification of the donee. Sec. 170(b)(2).

[40] Sec. 4941.

more of the foundation's exempt purposes, or with respect to amounts set-aside for the foundation's exempt purposes.

The proposal provides that qualifying distributions include that portion of reasonable and necessary administrative expenses that are directly attributable to direct charitable activities,[41] grant selection activities, grant monitoring and administration activities, compliance with applicable Federal, State, or local law, or furthering public accountability of the private foundation. Expenses that relate to multiple activities must be allocated to each activity. No specific method of allocation is required. However, the method used must be reasonable and used consistently by the organization.

The proposal provides that the following administrative expenses shall not be treated as qualifying distributions even if they are directly attributable to one or more of the activities described above: (1) compensation paid to persons who are disqualified persons within the meaning of section 4946(a), to the extent such compensation exceeds an annual rate of $100,000 (indexed for inflation); (2) air transportation expenses unless such transportation is regularly-scheduled commercial air transportation; and (3) air transportation expenses incurred for regularly-scheduled commercial air transportation to the extent that such expenses exceed the cost of such transportation for coach class accommodations. Actual cost for ground travel is allowed.

The proposal provides that the Secretary of the Treasury shall prescribe regulations as may be necessary to carry out the purposes of the proposal. Such regulations shall provide that administrative expenses that are excluded from qualifying distributions solely by reason of the limitations imposed by the proposal shall not for such reason subject a private foundation to any other excise taxes imposed by Subchapter A of Chapter 42 of the Code (i.e., sections 4940 through 4948).

Modification of excise tax on self-dealing

The proposal increases the initial excise tax imposed on a self-dealer from five percent to 25 percent of the amount involved with respect to the act of self-dealing for each year (or part thereof) in the taxable period.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2003.

[41] As used in the proposal, the term "direct charitable activity" has the same meaning as under present law, i.e., the direct active conduct of activities constituting the purpose or function for which the organization is organized and operated. Sec. 4942(j)(3)(A); Treas. Reg. sec. 53.4942(b)-1(b)(1). *See also* Instructions to Form 990-PF (2002), at 20-21.

G. Modify Tax on Unrelated Business Taxable Income of Charitable Remainder Trusts

Present Law

Charitable remainder annuity trusts and charitable remainder unitrusts are exempt from Federal income tax for a tax year unless the trust has any unrelated business taxable income for the year (including certain debt financed income). A charitable remainder trust that loses its exemption from income tax for a taxable year is taxed as a complex trust. As such, the trust is allowed a deduction in computing taxable income for amounts required to be distributed in a taxable year, not to exceed the amount of the trust's distributable net income for the year. Taxes imposed on the trust are required to be allocated to corpus.[42]

Distributions from a charitable remainder annuity trust or charitable remainder unitrust are treated in the following order as: (1) ordinary income to the extent of the trust's current and previously undistributed ordinary income for the trust's year in which the distribution occurred, (2) capital gains to the extent of the trust's current capital gain and previously undistributed capital gain for the trust's year in which the distribution occurred, (3) other income (e.g., tax-exempt income) to the extent of the trust's current and previously undistributed other income for the trust's year in which the distribution occurred, and (4) corpus.[43]

In general, distributions to the extent they are characterized as income are includible in the income of the beneficiary for the year that the annuity or unitrust amount is required to be distributed even though the annuity or unitrust amount is not distributed until after the close of the trust's taxable year.[44]

A charitable remainder annuity trust is a trust that is required to pay, at least annually, a fixed dollar amount of at least five percent of the initial value of the trust to a noncharity for the life of an individual or for a period of 20 years or less, with the remainder passing to charity. A charitable remainder unitrust is a trust that generally is required to pay, at least annually, a fixed percentage of at least five percent of the fair market value of the trust's assets determined at least annually to a noncharity for the life of an individual or for a period of 20 years or less, with the remainder passing to charity.[45]

A trust does not qualify as a charitable remainder annuity trust if the annuity for a year is greater than 50 percent of the initial fair market value of the trust's assets. A trust does not qualify as a charitable remainder unitrust if the percentage of assets that are required to be distributed at least annually is greater than 50 percent. A trust does not qualify as a charitable

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[42] Treas. Reg. sec. 1.664-1(d)(2).

[43] Sec. 664(b).

[44] Treas. Reg. sec. 1.664-1(d)(4).

[45] Sec. 664(d).

remainder annuity trust or a charitable remainder unitrust unless the value of the remainder interest in the trust is at least 10 percent of the value of the assets contributed to the trust.

Description of Proposal

Under the proposal, in lieu of removing the income tax exemption of a charitable remainder trust for any taxable year in which the trust has any unrelated business taxable income, a 100-percent excise tax is imposed on the unrelated business taxable income of the trust. Because the effect of the excise tax is the same as if the unrelated business taxable income was not incurred by the charitable remainder annuity trust or charitable remainder unitrust, the provision excludes such income from the determination of (1) the value of a charitable remainder unitrust's assets,[46] (2) the amount of charitable remainder unitrust income for purposes of determining the unitrust's required distributions, and (3) the effect on the income character of any distributions to beneficiaries by a charitable remainder annuity trust or charitable remainder unitrust.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2003.

[46] *See* Treas. Reg. sec. 1.664-3(a)(iv), which requires that all assets and liabilities of the trust are taken into account in determining their net fair market value.

H. Expand Charitable Contribution Allowed for Scientific Property Used for Research and for Computer Technology and Equipment

Present Law

In the case of a charitable contribution of inventory or other ordinary-income or short-term capital gain property, the amount of the charitable deduction generally is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose. In cases involving contributions to a private foundation (other than certain private operating foundations), the amount of the deduction is limited to the taxpayer's basis in the property.[47]

Under present law, a taxpayer's deduction for charitable contributions of scientific property used for research and for contributions of computer technology and equipment generally is limited to the taxpayer's basis (typically, cost) in the property. However, certain corporations may claim a deduction in excess of basis for a "qualified research contribution" or a "qualified computer contribution."[48] This enhanced deduction is equal to the lesser of (1) basis plus one-half of the item's appreciated value (i.e., basis plus one half of fair market value minus basis) or (2) two times basis. The enhanced deduction for qualified computer contributions expires for any contribution made during any taxable year beginning after December 31, 2003.

A qualified research contribution means a charitable contribution of inventory that is tangible personal property and that satisfies other requirements. The contribution must be to a qualified educational or scientific organization and be made not later than two years after construction of the property is substantially completed. The original use of the property must be by the donee, and the property must be used substantially for research or experimentation, or for research training, in the U.S. in the physical or biological sciences. The property must be scientific equipment or apparatus, constructed by the taxpayer, and may not be transferred by the donee in exchange for money, other property, or services. The donee must provide the taxpayer with a written statement representing that it will use the property in accordance with the conditions for the deduction. For purposes of the enhanced deduction, property is considered constructed by the taxpayer only if the cost of the parts used in the construction of the property (other than parts manufactured by the taxpayer or a related person) do not exceed 50 percent of the taxpayer's basis in the property.

A qualified computer contribution means a charitable contribution of any computer technology or equipment, which meets standards of functionality and suitability as established by the Secretary of the Treasury. The contribution must be to certain educational organizations or public libraries and made not later than three years after the taxpayer acquired the property or, if the taxpayer constructed the property, not later than the date construction of the property is

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[47] Sec. 170(e)(1).

[48] Secs. 170(e)(4) and 170(e)(6).

substantially completed.[49] The original use of the property must be by the donor or the donee,[50] and in the case of the donee, the property must be used substantially for educational purposes related to the function or purpose of the donee. The property must fit productively into the donee's education plan. The donee may not transfer the property in exchange for money, other property, or services, except for shipping, installation, and transfer costs. To determine whether property is constructed by the taxpayer, the rules applicable to qualified research contributions apply. Contributions may be made to private foundations under certain conditions.[51]

Description of Proposal

Under the proposal, property assembled by the taxpayer, in addition to property constructed by the taxpayer, is eligible for either enhanced deduction.

The proposal makes permanent the enhanced deduction for qualified computer contributions.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2003.

[49] If the taxpayer constructed the property and reacquired such property, the contribution must be within three years of the date the original construction was substantially completed. Sec. 170(e)(6)(D)(i).

[50] This requirement does not apply if the property was reacquired by the manufacturer and contributed. Sec. 170(e)(6)(D)(ii).

[51] Sec. 170(e)(6)(C).

I. Basis Adjustment to Stock of S Corporation Contributing Property

Present Law

Under present law, if an S corporation contributes money or other property to a charity, each shareholder takes into account the shareholder's pro rata share of the contribution in determining its own income tax liability.[52] A shareholder of an S corporation reduces the basis in the stock of the S corporation by the amount of the charitable contribution that flows through to the shareholder.[53]

Description of Proposal

The proposal provides that the amount of a shareholder's basis reduction in the stock of an S corporation by reason of a charitable contribution made by the corporation equals the shareholder's pro rata share of the adjusted basis of the contributed property.[54]

Thus, for example, assume an S corporation with one individual shareholder makes a charitable contribution of stock with a basis of $200 and a fair market value of $500. The shareholder is treated as having made a $500 charitable contribution (or a lesser amount if the special rules of section 170(e) apply), and reduces the basis of the S corporation stock by $200.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2003.

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[52] Sec. 1366(a)(1)(A).

[53] Sec. 1367(a)(2)(B).

[54] *See* Rev. Rul. 96-11 (1996-1 C.B. 140) for a rule reaching a similar result in the case of charitable contributions made by a partnership.

J. Charitable Organizations Permitted to Make Certain Collegiate Housing Grants

Present Law

Social clubs described in section 501(c)(7) are organizations generally exempt from tax that are organized for pleasure, recreation, and other nonprofitable purposes, substantially all of the activities of which are for such purposes and no part of the net earnings of which inures to the benefit of any person having a personal and private interest in the activities of the organization.[55] In general, fraternities and sororities provide fraternal, recreational, and social activities for their members who are students that attend a college or university and qualify as exempt social clubs.[56]

Under present law, a charitable organization described in section 501(c)(3) may provide, consistent with its exempt purposes, financial assistance to support the charitable and educational purposes of social clubs, such as fraternities and sororities. Social and recreational purposes of a fraternity or sorority, however, are not charitable or educational purposes within the meaning of section 501(c)(3).[57]

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and the fair market value of property contributed to an organization described in section 501(c)(3).[58] Within certain limitations, donors also are entitled to deduct their contributions to section 501(c)(3) organizations for Federal estate and gift tax purposes.[59]

Description of Proposal

The proposal provides that for purposes of sections 501(c)(3), 170(c)(2)(B), 2055(a), and 2522(a)(2), an organization shall not fail to be treated as organized and operated exclusively for charitable or educational purposes solely because such organization makes certain collegiate housing and infrastructure grants to qualifying recipient organizations. The proposal applies to

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[55] Sec. 501(c)(7); Treas. Reg. sec. 1.501(a)-1(c).

[56] Rev. Rul. 69-573, 1969-2 C.B.125; Rev. Rul. 64-118, 1964-1 C.B. (Part 1) 182.

[57] Rev. Rul. 69-573, 1969-2 C.B. 125 (noting that although the typical college fraternity does in some degree contribute to the cultural and educational growth of its members during their student years, this is not its primary purpose, which is fraternal, recreational and social in nature).

[58] Sec. 170(c)(2). The deduction also is allowed for purposes of calculating alternative minimum taxable income. The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer. Secs. 170(b) and (e).

[59] Secs. 2055(a)(2) and 2522(a)(2).

grants to provide, improve, operate, or maintain collegiate housing that may involve more than incidental social, recreational, or private purposes, so long as the grants are to be used by the recipient organization for purposes that would be permissible for a dormitory of the college or university described in section 501(c)(3) with which such organization is associated.[60] The grant recipient must be an organization described in section 501(c)(7), or a title holding company described in section 501(c)(2) that holds property exclusively for the benefit of an organization described in section 501(c)(7). Further, at the time the grant is made, substantially all of the active members of the recipient organization (or, if the recipient is a title holding company, the affiliated social club) must be full-time students at the college or university with which such organization is associated.

Effective Date

The proposal is effective for grants made after December 31, 2003.

[60] The proposal does not apply to the portion of a grant made for use by the recipient organization for physical fitness equipment.

K. Proceeds From Certain Games of Chance Treated as Income Related to Exempt Purposes

Present Law

Charitable and other organizations generally exempt from tax are subject to tax on their unrelated business taxable income.[61] In general, unrelated business taxable income is the gross income derived from an unrelated trade or business regularly carried on by the organization, less deductions that are directly connected with carrying on the business. An unrelated trade or business does not include any trade or business that consists of conducting bingo games.[62] A bingo game is any game of bingo of a type in which usually: (1) the wagers are placed, the winners are determined, and the distribution of prizes or other property is made in the presence of all persons placing wagers in such game; (2) the conducting of which is not an activity ordinarily carried out on a commercial basis; (3) and the conducting of which does not violate any State or local law.

Gaming activities other than bingo generally are treated as an unrelated trade or business and the proceeds therefore are subject to the unrelated business income tax. However, consistent with the IRS's acquiescence in the result of *South End Italian Independent Club, Inc. v. Commissioner*,[63] organizations may under present law deduct certain expenditures of gaming proceeds in calculating unrelated business income tax liability, thus enabling organizations to reduce, and in some cases eliminate, unrelated business income tax liability. Deductible expenditures generally do not include gaming proceeds that are accumulated for future use or transferred to the organization's general fund,[64] but do include amounts disbursed to further charitable purposes that are required by State law as a condition of conducting the gaming activity.

Description of Proposal

The proposal provides that any trade or business that consists of conducting qualifying games of chance is not an unrelated trade or business, so long as the net proceeds from the games of chance are paid or set aside for payment for purposes described in section 170(c)(2)(B), the promotion of social welfare as described in section 501(c)(4), or for a purpose for which State law specifically authorizes the expenditures of such proceeds. A qualified game of chance means any game of chance (other than bingo) conducted by an organization if: (1) such organization is licensed pursuant to State law to conduct such game; (2) only organizations that are organized as nonprofit corporations or are exempt from tax under section 501(a) may be so licensed to conduct such game within the State; and (3) the conduct of such game does not violate State or local law.

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[61] Sec. 511.

[62] Sec. 513(f).

[63] 87 T.C. 168 (1986), acq. in result, 1987-2 C.B. 1.

[64] *See, e.g., Women of the Motion Picture Indus. v. Commissioner*, T.C. Memo 1997-518.

Effective Date

The proposal is effective for games conducted after December 31, 2003.

L. Excise Taxes Exemption for Blood Collector Organizations

Present Law

American National Red Cross

The American National Red Cross ("Red Cross") is a Congressionally chartered corporation. It is responsible for giving aid to members of the U.S. Armed Forces, to disaster victims in the United States and abroad to help people prevent, prepare for, and respond to emergencies.[65] The Red Cross is responsible for half of the nation's blood supply and blood products.[66]

Exemption from certain retail and manufacturers excise taxes

The Code permits the Secretary to exempt from excise tax certain articles and services to be purchased for the exclusive use of the United States. This authority is conditioned upon the Secretary determining (1) that the imposition of such taxes will cause substantial burden or expense which can be avoided by granting tax exemption and (2) that full benefit of such exemption, if granted, will accrue to the United States.

On April 18, 1979, the Secretary exercised this authority to exempt, with limited exceptions, the Red Cross from the taxes imposed by chapters 31 and 32 of the Code with respect to articles sold to the Red Cross for its exclusive use.[67] An exemption is also authorized from the taxes imposed with respect to tires and inner tubes if such tire or inner tube is sold by any person on or in connection with the sale of any article to the American National Red Cross, for its exclusive use.[68] No exemption is provided from the gas guzzler tax (sec. 4064), and the taxes imposed on aviation fuel, on fuel used on inland waterways (sec. 4042), and on coal (sec. 4121).[69] The exemption is subject to registration requirements for tax-free sales contained in Treasury regulations. Credit and refund of tax is subject to the requirements set forth is section

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[65] *See* 36 U.S.C. sec. 300102.

[66] American Red Cross, *Frequently Asked Questions* http://www.redcross.org/sys/search/faqnew.asp (April 11, 2003).

[67] Department of the Treasury, *Notice-Manufacturers and Retailers Excise Taxes - Exemption from Tax of Sales of Certain Articles to the American Red Cross*, 44 F.R. 23407, 1979-1 C.B. 478 (1979). At the time the notice was issued the following taxes were covered in Chapters 31 and 32: special fuels, automotive and related items (motor vehicles, tires and tubes, petroleum products, coal, and recreational equipment (sporting goods and firearms). Chapter 32 now covers aviation fuel taxes under section 4091 and the taxes under section 4041(c) serve today as a backup tax.

[68] Under present law, there is no longer a tax on inner tubes.

[69] *Id*. The Treasury notice also exempts the Red Cross from tax on aircraft tires and tubes, however, present law currently limits the tax to highway vehicle tires (sec. 4071(a)).

6416 relating to the exemption for taxable articles sold for the exclusive use of State and local governments.

Exemption from heavy highway motor vehicle use tax

An annual use tax is imposed on highway motor vehicles, at the rates below (sec. 4481).

Under 55,000 pounds	No tax
55,000-75,000 pounds	$100 plus $22 per 1,000 pounds over 55,000
Over 75,000 pounds	$550

The Code provides that the Secretary may authorize exemption from the heavy highway vehicle use tax as to the use by the United States of any particular highway motor vehicle or class of highway motor vehicles if the Secretary determines that the imposition of such tax with respect to such use will cause substantial burden or expense which can be avoided by granting tax exemption and that the full benefit of such exemption, if granted will accrue to the United States (sec. 4483(b)). The IRS has ruled that the Red Cross comes within the term "United States" for purposes of the exemption from the heavy highway motor vehicle use tax (Rev. Rul. 76-510).

Exemption from communications excise tax

The Code imposes a three-percent tax on amounts paid for local telephone service; toll telephone service and teletypewriter exchange service (sec. 4251). These taxes do not apply to amounts paid for services furnished to the Red Cross (sec. 4253(c)).

Certain other tax-free sales

Exemption from certain manufacturer and retail sale excise taxes

The following sales generally are exempt from certain manufacturer and retail sale excise taxes: (1) for use by the purchaser for further manufacture, or for resale to a second purchaser in further manufacture; (2) for export or for resale to a second purchaser for export; (3) for use by the purchaser as supplies for vessels or aircraft; (4) to a State or local government for the exclusive use of a State or local government; and (5) to a nonprofit educational organization for its exclusive use (sec. 4221). The exemption generally applies to manufacturers taxes imposed by chapter 32 of the Code (the gas guzzlers tax, and the taxes imposed on tires, certain vaccines, and recreational equipment) and the tax on retail sales of heavy trucks and trailers.[70]

The manufacturers excise taxes on coal (sec. 4121), on gasoline, diesel fuel, and kerosene (sec. 4081) and on aviation fuel (sec. 4091) are not covered by the exemption. The exemption for a sale to a State or local government for their exclusive use and the exemption for sales to a nonprofit educational organization does not apply to the gas guzzlers tax, and the tax on

[70] The tax imposed by subchapter A of chapter 31 (relating to luxury passenger vehicles) are also exempt pursuant to this provision, however, this tax expired on December 31, 2002. (sec. 4001(g).)

vaccines. In addition, the exemption of sales for use as supplies for vessels and aircraft does not apply to the vaccine tax.

Exempt sales of special fuels

A retail excise tax is imposed on special fuels such as propane, compressed natural gas, and certain alcohol mixtures (sec. 4041). No tax is imposed on these fuels: (1) sold for use or used as supplies for vessels or aircraft, (2) sold for the exclusive use of any State, any political subdivision of a State, or the District of Columbia or is used by such entity as fuel, (3) sold for export, or for shipment to a possession of the United States and is actually exported or shipped, (4) sold to a nonprofit educational organization for its exclusive use, or used by such entity as fuel (sec. 4041(g)).

Credits and refunds

In general

A credit or refund is allowed for overpayment of manufacturers or retail excise taxes (sec. 6416). Overpayments include (1) certain uses and resales, (2) price adjustments, and (3) further manufacture.

Specified uses and resales

The special fuel taxes, the retail tax on heavy trucks and trailers, and any of the manufacturers excise taxes paid on any article will be a deemed overpayment subject to credit or refund if sold for certain specified uses (sec. 6416(b)(2)). These uses are (1) export, (2) used or sold for use as supplies for vessels or aircraft, (3) sold to a State or local government for the exclusive use of a State or local government, (4) sold to a nonprofit educational organization for its exclusive use; (5) taxable tires sold to any person for use in connection with a qualified bus, or (6) the case of gasoline used or sold for use in the production of a special fuel. Certain exceptions apply in that this deemed overpayment rule does not apply to diesel fuel (sec. 4041(a)(1)), kerosene (sec. 4081), aviation fuel (sec. 4091), and coal taxes (sec. 4121). Additionally, the deemed overpayment rule does not apply to the gas guzzler tax in the case of an article sold to a state or local government for its exclusive use or sold to an educational organization for its exclusive use.

Special rule for tires sold in connection with other articles

If the tax imposed on tires (sec. 4071) has been paid with respect to the sale of any tire by the manufacturer, producer, or importer, and such tire is sold by any person in connection with the sale of any other article, such tax will be deemed an overpayment by person if such other article (1) is an automobile bus chassis or an automobile bus body, or (2) is by any person exported, sold to a State or local government for exclusive use of a State or local government, sold to a nonprofit educational organization for its exclusive use, or used or sold for use as supplies for vessels or aircraft (sec. 6416(b)(4)).

Gasoline used for exempt purposes

If gasoline is sold to any person for certain specified purposes, the Secretary is required to pay (without interest) to such person an amount equal to the product of the number of gallons of gasoline so sold multiplied by the rate at which tax was imposed on such gasoline under section 4081 (sec. 6421(c)). Under this provision, the specified purposes are (1) for export or for resale to a second purchaser for export; (2) for use by the purchaser as supplies for vessels or aircraft; (3) to a State or local government for exclusive use of a State or local government; and (4) to a nonprofit educational organization for its exclusive use (sec. 4221(a), 6421(c)).

Diesel fuel, kerosene and aviation fuel used in a nontaxable use

If diesel fuel, kerosene, or aviation fuel, upon which tax has been imposed is used by any person in a nontaxable use, the Code authorizes the Secretary to pay (without interest) to the ultimate purchaser of such fuel an amount equal to the aggregate amount of tax imposed on such fuel (sec. 6427(l)). Nontaxable uses include any exemption under the rules governing special fuels (except prior taxation).

Description of Proposal

The proposal exempts qualified blood collector organizations from certain retail and manufacturers excise taxes to the extent such items are for the exclusive use of such an organization. A qualified blood collector organization means an organization that is (1) described in section 501(c)(3) and exempt from tax under section 501(a), (2) registered by the Food and Drug Administration to collect blood, and (3) primarily engaged in the activity of the collection of blood.

Under the proposal, qualified blood collector organizations are exempt from the communications excise tax as provided by Treasury regulations. The proposal also provides an exemption from the special fuels tax, and certain taxes imposed by chapter 32 and subchapter A and C of chapter 31 of the Code (i.e., the retail excise tax on heavy trucks and trailers, and the manufacturers excise taxes on tires, vaccines, and recreational equipment (sport fishing equipment, bows, arrow components, and firearms)).[71] The proposal also makes conforming amendments to allow for the credit or refund of these taxes and any tax paid on gasoline for the exclusive use of the blood collector organization. The proposal also permits a refund of tax for diesel fuel, kerosene or aviation fuel used by a qualified blood collector organization.

Effective Date

The proposal is effective on January 1, 2004.

[71] Such organizations are also exempt from the expired retail excise tax on luxury passenger vehicles. No exemption is provided from the gas guzzler tax (sec. 4064), and the taxes imposed on fuel used on inland waterways (sec. 4042), and on coal (sec. 4121).

M. Nonrecognition of Gain on the Sale of Property Used in the Performance of an Exempt Function

Present Law

The unrelated business taxable income of organizations described in sections 501(c)(7) (social clubs), 501(c)(9) (voluntary employees' beneficiary associations), and 501(c)(17) (supplemental unemployment compensation benefit organizations) includes all gross income, less deductions directly connected with producing that income, but not including exempt function income.[72] For this purpose, exempt function income is gross income from dues, fees, charges, or similar items paid by members to an organization for the purposes for which exempt status was granted to such organization. Investment income of such organizations generally is not taxed if set aside to be used for religious, charitable, scientific, literary, or educational purposes or for the prevention of cruelty to children or animals.[73]

Gain on the sale of property by an organization described in sections 501(c)(7), 501(c)(9), or 501(c)(17) that was used directly in performing an exempt function of the organization generally is taxed as unrelated business taxable income. An organization may reduce the amount of gain to be recognized from such sales, however, if the organization purchases other property that is used directly in performing an exempt function.[74] In such cases, gain is recognized only to the extent that the sales price of the sold property exceeds the cost of purchasing the replacement property. The replacement property must be acquired by the organization within the period beginning one year before, and ending three years after, the date of sale of the sold property. For these purposes, a sale of property includes the property's destruction in whole or in part, theft, seizure, requisition, or condemnation.

Description of Proposal

The proposal extends the replacement period for acquisitions of replacement property from four years to eleven years with respect to the sales of property by social clubs described in section 501(c)(7). A social club that sells property used directly in the performance of its exempt function recognizes gain from such a sale only to the extent that the organization's sales price of such property exceeds the organization's cost of purchasing other property, during a period beginning one year before the date of sale and ending ten years after such date, that is used directly in the performance of the exempt function of the organization.

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[72] Sec. 512(a)(3). Present law refers to section 501(c)(20) organizations (group legal services plans). Section 501(c)(20) is not effective for taxable years beginning after June 30, 1992.

[73] Subject to certain limitations, the investment income of organizations described in section 501(c)(9) or 501(c)(17) generally is not taxed if it is set aside to provide for the payment of life, sick, accident, or other benefits. Secs. 512(a)(3)(B)(ii) and 512(a)(3)(E).

[74] Sec. 512(a)(3)(D).

The proposal provides an extended limitations period with respect to the assessment of a deficiency in such cases.

Effective Date

The proposal is effective for the sale of property for which the three-year period for offsetting gain by purchasing other property under section 512(a)(3)(D) (as in effect on the day before the date of enactment of the proposal) had not expired as of January 1, 2001.

N. Qualified 501(c)(3) Bonds for Nursing Homes Exempt from Federal Guarantee Prohibition

Present Law

Qualified 501(c)(3) bonds

Interest on State or local government bonds is tax-exempt when the proceeds of the bonds are used to finance activities carried out by or paid for by those governmental units. Interest on bonds issued by State or local governments acting as conduit borrowers for private businesses is taxable unless a specific exception is included in the Code. One such exception allows tax-exempt bonds to be issued to finance activities of non-profit organizations described in section 501(c)(3) ("qualified 501(c)(3) bonds"). A 501(c)(3) organization could provide, among other things, low-income housing facilities, assisted living facilities, nursing homes, hospitals, and homes for the aged.

For a bond to be a qualified 501(c)(3) bond, the bond must meet certain requirements. The property that is to be provided by the net proceeds of the issue must be owned by a 501(c)(3) organization, or by a government unit. In addition, a bond failing both a modified private business use test and a modified private security or payment test would not be a qualified 501(c)(3) bond. Under the modified private business use test at least 95 percent of the net proceeds of the bond must be used by a 501(c)(3) organization in furtherance of its exempt purpose. Under a modified private security or payment test, the debt service on not more than 5 percent of the net proceeds of the bond issue can be (1) secured by an interest in property, or payments in respect of property, used by a 501(c)(3) organization in furtherance of an unrelated trade or business or by a private user, or (2) derived from payments in respect of property, or borrowed money, used by a 501(c)(3) organization in furtherance of an unrelated trade or business or by a private user.

Federal guarantee prohibition

Subject to exceptions for certain Federal programs in existence before 1984, interest on any obligation is not tax-exempt if the obligation is Federally guaranteed. An obligation is treated as Federally guaranteed if (1) the payment of the principal or interest on the obligation is guaranteed (directly or indirectly), in whole or in part, by the United States or any agency or instrumentality thereof; or (2) five percent or more of the proceeds of the issue of which the obligation is a part is to be (i) used in making loans the payment of principal or interest on which are guaranteed in whole or in part by the United States or any agency or instrumentality thereof or, (ii) invested, directly or indirectly, in Federally insured deposits or accounts in a financial institution.

The Code provides exceptions to the Federal guarantee prohibition for certain insurance programs. Specifically, a bond is not treated as Federally guaranteed by reason of any guarantee by the Federal Housing Administration, the Veterans' Administration, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, or the Government National Mortgage Association, any guarantee of student loans and any guarantee by the Student Loan Marketing Association to finance student loans, or any guarantee by the Bonneville Power

Authority pursuant to the Northwest Power Act (16 U.S.C. 839d) as in effect on the date of the enactment of the Tax Reform Act of 1984.

The Code also excludes certain housing-related bond issues, proceeds invested for an initial temporary period until needed for the purpose for which such issue was issued, bona fide debt service fund investments, investments in a reasonably required reserve fund, investments in United States Treasury obligations, and other investments permitted by regulation.

Description of Proposal

Under the proposal, the Federal guarantee prohibition will not apply to qualified 501(c)(3) bonds supported by a letter of credit and issued for the benefit of an organization described in subsection 501(c)(3), if such bonds are part of an issue, the proceeds of which are used to finance one or more of the following facilities primarily for the benefit of the elderly: (1) licensed nursing home facilities, (2) licensed or certified assisted living facilities, (3) licensed personal care facilities, or (4) continuing care retirement communities. The proposal is limited to $15 million or less of aggregate bond issuance per issuer per calendar year. Also, no more than $15 million of eligible debt may be outstanding per user under this proposal.

"Continuing care retirement community" means a community that provides, on the same campus, a continuum of residential living options and support services to persons sixty (60) years of age or older under a written agreement. The residential living options shall include independent living units, nursing home beds, and either assisted living units or personal care beds.

Effective Date

The proposal is effective for bonds issued after December 31, 2003, and before the date which is one year after the date of enactment.

II. TAX REFORM AND IMPROVEMENTS RELATING TO CHARITABLE ORGANIZATIONS AND PROGRAMS

A. Suspension of Tax-Exempt Status of Terrorist Organizations

Present Law

Under present law, the Internal Revenue Service generally issues a letter revoking recognition of an organization's tax-exempt status only after (1) conducting an examination of the organization, (2) issuing a letter to the organization proposing revocation, and (3) allowing the organization to exhaust the administrative appeal rights that follow the issuance of the proposed revocation letter. In the case of an organization described in section 501(c)(3), the revocation letter immediately is subject to judicial review under the declaratory judgment procedures of section 7428. To sustain a revocation of tax-exempt status under section 7428, the IRS must demonstrate that the organization is no longer entitled to exemption. There is no procedure under current law for the IRS to suspend the tax-exempt status of an organization.

To combat terrorism, the Federal government has designated a number of organizations as terrorist organizations or supporters of terrorism under the Immigration and Nationality Act, the International Emergency Economic Powers Act, and the United Nations Participation Act of 1945.

Description of Proposal

The proposal suspends the tax-exempt status of an organization that is exempt from tax under section 501(a) for any period during which the organization is designated or identified by U.S. Federal authorities as a terrorist organization or supporter of terrorism. The proposal also makes such an organization ineligible to apply for tax exemption under section 501(a). The period of suspension runs from the date the organization is first designated or identified (or from the date of enactment of the provision, whichever is later) to the date when all designations or identifications with respect to the organization have been rescinded pursuant to the law or Executive order under which the designation or identification was made.

The proposal describes a terrorist organization as an organization that has been designated or otherwise individually identified (1) as a terrorist organization or foreign terrorist organization under the authority of section 212(a)(3)(B)(vi)(II) or section 219 of the Immigration and Nationality Act; (2) in or pursuant to an Executive order that is related to terrorism and issued under the authority of the International Emergency Economic Powers Act or section 5 of the United Nations Participation Act for the purpose of imposing on such organization an economic or other sanction; or (3) in or pursuant to an Executive order that refers to the proposal and is issued under the authority of any Federal law if the organization is designated or otherwise individually identified in or pursuant to such Executive order as supporting or engaging in terrorist activity (as defined in section 212(a)(3)(B) of the Immigration and Nationality Act) or supporting terrorism (as defined in section 140(d)(2) of the Foreign Relations Authorization Act, Fiscal Years 1988 and 1989). During the period of suspension, no deduction for any contribution to a terrorist organization is allowed under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522.

No organization or other person may challenge, under section 7428 or any other provision of law, in any administrative or judicial proceeding relating to the Federal tax liability of such organization or other person, the suspension of tax-exemption, the ineligibility to apply for tax-exemption, a designation or identification described above, the period of suspension, or a denial of a deduction described above. The suspended organization may maintain other suits or administrative actions against the agency or agencies that designated or identified the organization, for the purpose of challenging such designation or identification (but not the suspension of tax-exempt status under this provision).

If the tax-exemption of an organization is suspended and each designation and identification that has been made with respect to the organization is determined to be erroneous pursuant to the law or Executive order making the designation or identification, and such erroneous designation results in an overpayment of income tax for any taxable year with respect to such organization, a credit or refund (with interest) with respect to such overpayment shall be made. If the operation of any law or rule of law (including res judicata) prevents the credit or refund at any time, the credit or refund may nevertheless be allowed or made if the claim for such credit or refund is filed before the close of the one-year period beginning on the date that the last remaining designation or identification with respect to the organization is determined to be erroneous.

The proposal directs the IRS to update the listings of tax-exempt organizations to take account of organizations that have had their exemption suspended and to publish notice to taxpayers of the suspension of an organization's tax-exemption and the fact that contributions to such organization are not deductible during the period of suspension.

Effective Date

The proposal is effective for designations made before, on, or after the date of enactment.

B. Clarification of Definition of Church Tax Inquiry

Present Law

Under present law, the IRS may begin a church tax inquiry only if an appropriate high-level Treasury official reasonably believes, on the basis of the facts and circumstances recorded in writing, that an organization (1) may not qualify for tax exemption as a church, (2) may be carrying on an unrelated trade or business, or (3) otherwise may be engaged in taxable activities.[75] A church tax inquiry is defined as any inquiry to a church (other than an examination) that serves as a basis for determining whether the organization qualified for tax exemption as a church or whether it is carrying on an unrelated trade or business or otherwise is engaged in taxable activities. An inquiry is considered to commence when the IRS requests information or materials from a church of a type contained in church records, other than routine requests for information or inquiries regarding matters that do not primarily concern the tax status or liability of the church itself.

Description of Proposal

The proposal clarifies that the church tax inquiry procedures do not apply to contacts made by the IRS for the purpose of educating churches with respect to the federal income tax law governing tax-exempt organizations. For example, the IRS does not violate the church tax inquiry procedures when written materials are provided to a church or churches for the purpose of educating such church or churches with respect to the types of activities that are not permissible under section 501(c)(3).

Effective Date

The proposal is effective on the date of enactment.

[75] Sec. 7611.

C. Extension of Declaratory Judgment Procedures to Non-501(c)(3) Tax-Exempt Organizations

Present Law

In order for an organization to be granted tax exemption as a charitable entity described in section 501(c)(3), it generally must file an application for recognition of exemption with the IRS and receive a favorable determination of its status. Similarly, for most organizations, a charitable organization's eligibility to receive tax-deductible contributions is dependent upon its receipt of a favorable determination from the IRS. In general, a section 501(c)(3) organization can rely on a determination letter or ruling from the IRS regarding its tax-exempt status, unless there is a material change in its character, purposes, or methods of operation. In cases in which an organization violates one or more of the requirements for tax exemption under section 501(c)(3), the IRS is authorized to revoke an organization's tax exemption, notwithstanding an earlier favorable determination.

In situations in which the IRS denies an organization's application for recognition of exemption under section 501(c)(3) or fails to act on such application, or in which the IRS informs a section 501(c)(3) organization that it is considering revoking or adversely modifying its tax-exempt status, present law authorizes the organization to seek a declaratory judgment regarding its tax status (sec. 7428). Section 7428 provides a remedy in the case of a dispute involving a determination by the IRS with respect to: (1) the initial qualification or continuing qualification of an organization as a charitable organization for tax exemption purposes or for charitable contribution deduction purposes; (2) the initial classification or continuing classification of an organization as a private foundation; (3) the initial classification or continuing classification of an organization as a private operating foundation; or (4) the failure of the IRS to make a determination with respect to (1), (2), or (3). A "determination" in this context generally means a final decision by the IRS affecting the tax qualification of a charitable organization, although it also can include a proposed revocation of an organization's tax-exempt status or public charity classification. Section 7428 vests jurisdiction over controversies involving such a determination in the U.S. District Court for the District of Columbia, the U.S. Court of Federal Claims, and the U.S. Tax Court.

Prior to utilizing the declaratory judgment procedure, an organization must have exhausted all administrative remedies available to it within the IRS. An organization is deemed to have exhausted its administrative remedies at the expiration of 270 days after the date on which the request for a determination was made if the organization has taken, in a timely manner, all reasonable steps to secure such determination.

If an organization (other than a section 501(c)(3) organization) files an application for recognition of exemption and receives a favorable determination from the IRS, the determination of tax-exempt status is usually effective as of the date of formation of the organization if its purposes and activities during the period prior to the date of the determination letter were consistent with the requirements for exemption. However, if the organization files an application for recognition of exemption and later receives an adverse determination from the IRS, the IRS may assert that the organization is subject to tax on some or all of its income for open taxable

years. In addition, as with charitable organizations, the IRS may revoke or modify an earlier favorable determination regarding an organization's tax-exempt status.

Under present law, a non-charity (i.e., an organization not described in section 501(c)(3)) may not seek a declaratory judgment with respect to an IRS determination regarding its tax-exempt status. The only remedies available to such an organization are to petition the U.S. Tax Court for relief following the issuance of a notice of deficiency or to pay any tax owed and sue for refund in Federal district court or the U.S. Court of Federal Claims.

Description of Proposal

The proposal extends declaratory judgment procedures similar to those currently available only to charities under section 7428 to other section 501(c) and 501(d) determinations. The proposal limits jurisdiction over controversies involving such other determinations to the United States Tax Court.[76]

Effective Date

The extension of the declaratory judgment procedures to organizations other than section 501(c)(3) organizations is effective for pleadings filed with respect to determinations (or requests for determinations) made after the date of enactment.

[76] This limitation currently applies to declaratory judgments relating to tax qualification for certain employee retirement plans (sec. 7476).

D. Exclusion from Income of Certain Landowner Initiatives Program Payments

Present Law

Under present law, gross income does not include the excludable portion of payments made to taxpayers by Federal and state governments for a share of the cost of improvements to property under certain conservation programs. These programs include payments received under (1) the rural clean water program authorized by section 208(j) of the Federal Water Pollution Control Act; (2) the rural abandoned mine program authorized by section 406 of the Surface Mining Control and Reclamation Act of 1977; (3) the water bank program authorized by the Water Bank Act; (4) the emergency conservation measures program authorized by title IV of the Agricultural Credit Act of 1978; (5) the agriculture conservation program authorized by the Soil Conservation and Domestic Allotment Act; (6) the great plains conservation program authorized by section 16 of the Soil Conservation and Domestic Policy Act; (7) the resource conservation and development program authorized by the Bankhead-Jones Farm Tenant Act and by the Soil Conservation and Domestic Allotment Act; (8) the forestry incentives program authorized by section 4 of the Cooperative Forestry Assistance Act of 1978; (9) any small watershed program administered by the Secretary of Agriculture which is determined by the Secretary of the Treasury or his delegate to be substantially similar to the type of programs described in items (1) through (8); and (10) any program of a State, possession of the United States, a political subdivision of any of the foregoing, or the District of Columbia under which payments are made to individuals primarily for the purpose of conserving soil, protecting or restoring the environment, improving forests, or providing a habitat for wildlife.[77]

Under present law, the excludable portion of a program payment means that portion (or all) of a payment made to any person under the program that is determined by the Secretary of Agriculture to be made primarily for the purpose of conserving soil and water resources, protecting or restoring the environment, improving forests, or providing a habitat for wildlife, and is determined by the Secretary of the Treasury or his delegate as not increasing substantially the annual income derived from the property.

Description of Proposal

The proposal expands the types of qualified cost-sharing payments described in section 126 to include payments received under landowner initiatives programs to conserve threatened, endangered, or imperiled species, or protect or restore habitat carried out under: (1) the Fish and Wildlife Coordination Act (16 U.S.C. 661 et seq.); (2) the Fish and Wildlife Act of 1956 (16 U.S.C. 742f); or (3) section 6 of the Endangered Species Act (16 U.S.C. 11531 et seq.).

The proposal provides that the determination of the excludable portion of the landowner initiatives program payments described in the proposal shall be made by the Secretary of the

[77] Sec. 126.

Interior, rather than by the Secretary of Agriculture, if the programs are implemented by the Department of Interior.[78]

Effective Date

The proposal is effective for amounts received after December 31, 2003, in taxable years ending after such date.

[78] The proposal also provides that the excludable portion of payments received under a program described in present law section 126(a)(10), under which payments are made to individuals primarily for the purpose of conserving soil, protecting or restoring the environment, improving forests, or providing a habitat for wildlife, shall be determined by the Secretary of Interior, rather than by the Secretary of Agriculture, if the program is implemented by the Department of Interior.

E. Modify Tax Treatment of Certain Payments to Controlling Exempt Organizations

Present Law

In general, interest, rents, royalties, and annuities are excluded from the unrelated business income of tax-exempt organizations. However, section 512(b)(13) generally treats otherwise excluded rent, royalty, annuity, and interest income as unrelated business income if such income is received from a taxable or tax-exempt subsidiary that is 50 percent controlled by the parent tax-exempt organization. In the case of a stock subsidiary, "control" means ownership by vote or value of more than 50 percent of the stock. In the case of a partnership or other entity, control means ownership of more than 50 percent of the profits, capital or beneficial interests. In addition, present law applies the constructive ownership rules of section 318 for purposes of section 512(b)(13). Thus, a parent exempt organization is deemed to control any subsidiary in which it holds more than 50 percent of the voting power or value, directly (as in the case of a first-tier subsidiary) or indirectly (as in the case of a second-tier subsidiary).

Under present law, interest, rent, annuity, or royalty payments made by a controlled entity to a tax-exempt organization are includable in the latter organization's unrelated business income and are subject to the unrelated business income tax to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity (determined as if the entity were tax exempt).

The Taxpayer Relief Act of 1997 (the "1997 Act") made several modifications to the control requirement of section 512(b)(13). In order to provide transitional relief, the changes made by the 1997 Act do not apply to any payment received or accrued during the first two taxable years beginning on or after the date of enactment of the 1997 Act (August 5, 1997) if such payment is received or accrued pursuant to a binding written contract in effect on June 8, 1997, and at all times thereafter before such payment (but not pursuant to any contract provision that permits optional accelerated payments).

Description of Proposal

The proposal provides that the general rule of section 512(b)(13), which includes interest, rent, annuity, or royalty payments made by a controlled entity to a tax-exempt organization in the latter organization's unrelated business income to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity, applies only to the portion of payments received or accrued in a taxable year that exceeds the amount of the specified payment that would have been paid or accrued if such payment had satisfied the requirements prescribed under section 482. Thus, if a payment of rent by a controlled subsidiary to its tax-exempt parent organization exceeds fair market value, the excess amount of such payment over fair market value (as determined in accordance with section 482) is included in the parent organization's unrelated business income, to the extent that such excess reduced the net unrelated income (or increased any net unrelated loss) of the controlled entity (determined as if the entity were tax exempt). In addition, the provision imposes a 20-percent addition to tax on the larger of such excess determined without regard to any amendment or supplement to a return of tax, or such excess determined with regard to all such amendments and supplements.

The proposal provides that if modifications to section 512(b)(13) made by the 1997 Act did not apply to a contract because of the transitional relief provided by the 1997 Act, then such modifications also do not apply to amounts received or accrued under such contract before January 1, 2001.

Effective Date

The proposal applies to payments received or accrued after December 31, 2003.

F. Simplification of Lobbying Expenditure Limitation

Present Law

In general

An organization does not qualify for tax-exempt status under section 501(c)(3) unless "no substantial part" of the activities of the organization is "carrying on propaganda, or otherwise attempting, to influence legislation," except as provided by section 501(h).[79] Carrying on propaganda and attempting to influence legislation commonly are referred to as "lobbying" activities. Thus, section 501(c)(3) permits a limited amount of lobbying activity without loss of tax-exempt status.

For purposes of determining whether lobbying activities are a substantial part of an organization's overall functions, an organization generally may choose between two standards, the "no substantial part" test of section 501(c)(3) or the "expenditure" test of section 501(h).

Whether an organization meets the "no substantial part" test is based on all the facts and circumstances. There is no statutory or regulatory guidance, and it is not clear whether the determination is based on the organization's activities, its expenditures, or both. Alternatively, under section 501(h), certain organizations described in section 501(c)(3) can elect to be subject to the expenditure test,[80] which consists of bright-line rules that specify the dollar amount of permitted expenditures on lobbying activities.

Consequences of excess lobbying under section 501(h)

Organizations that make a section 501(h) election ("electing charities") are subject to tax if the electing charity makes either "lobbying expenditures" or "grass roots expenditures" in excess of a certain amount established for each type of expenditure for each taxable year. Lobbying expenditures are the sum of grass-roots expenditures and "direct lobbying" expenditures.[81]

The expenditure limits are based on a "lobbying nontaxable amount" for the taxable year and a "grass roots nontaxable amount" for the taxable year. The lobbying nontaxable amount is the lesser of $1 million or an amount determined as a percentage of an organization's exempt purpose expenditures.[82] The grass-roots nontaxable amount is 25 percent of the organization's

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[79] Sec. 501(c)(3).

[80] Organizations that do not make a section 501(h) election are subject to the "no substantial part" test.

[81] Secs. 501(h)(2)(A), 4911(c)(1), 4911(d).

[82] Exempt purpose expenditures generally are expenses incurred for exempt purposes, such as amounts paid to accomplish exempt purposes, administrative expenses such as overhead, lobbying expenses, and certain fundraising expenses. Exempt purpose expenditures do not include, for example, expenses not for exempt purposes, payments of unrelated business income

lobbying nontaxable amount. An electing charity that exceeds either of the spending limitations is subject to a 25 percent tax on the excess. An electing charity that exceeds both of the spending limitations is subject to a 25 percent tax on the greater of the excess of the lobbying expenditures or the grass-roots expenditures.

An electing charity that normally exceeds either of two "ceiling amounts," which are based on the expenditure limits, will lose its tax exemption.[83] The "lobbying ceiling amount" is 150 percent of the electing charity's lobbying nontaxable amount for the taxable year and the "grass roots ceiling amount" is 150 percent of the grass-roots nontaxable amount for the taxable year. For this purpose, "normal" expenditures are calculated based on a four-year averaging mechanism.[84]

Definitions

Grass-roots expenditures are defined as "any attempt to influence any legislation through an attempt to affect the opinions of the general public or any segment thereof."[85] For a communication to constitute grass-roots lobbying, it must refer to "specific legislation," reflect a view on such legislation, and encourage the recipient of the communication to take action with respect to such legislation (a "call to action").[86] A communication includes a call to action if it incorporates one of four elements: (1) it urges the recipient to contact a legislator, employee of a government body, or any other government official or employee who may participate in the formulation of legislation with the principal purpose of influencing legislation; (2) it states the address, telephone number, or similar information of a legislator or an employee of a legislative body; (3) it provides a petition, tear-off postcard, or similar device for the recipient to communicate with government officials or employees who participate in the formulation of legislation with the principal purpose of influencing legislation; or (4) it states the position of one or more legislators on the legislation, except that a communication may name the main sponsors of legislation for purposes of identifying the legislation without constituting a call to action.[87] In

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tax, or capital expenses in connection with an unrelated business. See Treas. Reg. sec. 56.4911-4.

[83] Sec. 501(h)(1).

[84] Treas. Reg. sec. 1.501(h)-3.

[85] Secs. 501(h)(2)(C) & 4911(d)(1)(A).

[86] Treas. Reg. sec. 56.4911-2(b)(2)(i).

[87] Treas. Reg. sec. 56.4911-2(b)(2)(iii). The regulations provide that the first three elements constitute "direct" encouragement, whereas the fourth element is "indirect" encouragement. This distinction becomes relevant in determining whether a communication meets one of the prescribed exceptions to lobbying, i.e., an indirect call to action in a grass-roots communication may qualify as "nonpartisan analysis, study or research" (Treas. Reg. sec. 56.4911-2(b)(2)(iv)), and in determining the proper allocation of expenses between grass-roots and direct lobbying. Treas. Reg. sec. 56.4911-5(e).

addition, a communication is presumed to be grass-roots lobbying if the communication is a paid advertisement that: (1) appears in the mass media within two weeks before a vote by a legislative body or committee (but not a subcommittee) on a highly publicized piece of legislation; (2) reflects a view on the general subject of the legislation; and (3) either refers to the legislation or encourages the public to communicate with legislators on the general subject of such legislation.[88] The presumption is rebuttable if the electing charity demonstrates that the timing of the communication was not related to the legislation or that the advertisement was of a type regularly made by the electing charity without regard to the timing of the legislation (a customary course of business exception).[89]

Direct lobbying expenditures are "any attempt to influence any legislation through communication with any member or employee of a legislative body, or with any government official or employee who may participate in the formulation of the legislation" if the principal purpose of the communication is to influence legislation.[90] A communication would constitute direct lobbying only if the communication "refers to specific legislation" and reflects a view on such legislation.

Certain specified activities do not constitute attempts to influence legislation and therefore expenditures for such activities are not subject to the expenditure limits for lobbying expenditures or grass-roots expenditures. In general, such activities include: (1) making available the results of nonpartisan analysis, study, or research; (2) providing technical advice or assistance to a governmental body or to a committee in response to a written request; (3) appearances before, or communications to, any legislative body with respect to a possible decision of such body that might affect the existence of the organization, its powers and duties, tax-exempt status, or the deduction of contributions to the organization (so-called "self-defense" expenditures); (4) certain communications to members of the electing charity; and (5) communications with governmental officials or employees that are not intended to influence legislation.[91]

Special rules for mixed lobbying expenditures

Expenses that serve both direct and grass-roots lobbying purposes, e.g., communications that are sent to members and nonmembers, or "mixed lobbying" expenditures, are subject to special rules. The regulations specify how an electing charity is to allocate mixed lobbying expenditures between direct and grass-roots lobbying purposes.[92] For example, for a mixed lobbying communication that is designed primarily for members (i.e., more than half the recipients are members) and that directly encourages grass-roots lobbying (even if it also

[88] Treas. Reg. sec. 56.4911-2(b)(5)(ii).

[89] *Id.*

[90] Secs. 501(h)(2)(A) and 4911(d)(1)(B) and Treas. Reg. sec. 56.4911-2(b)(1).

[91] Sec. 4911(d)(2).

[92] Treas. Reg. sec. 56.4911-5(e).

encourages direct lobbying), the grass-roots expenditure amount includes all the costs of preparing the material used for purposes of grass-roots lobbying plus the mechanical and distributional costs associated with the communication. If a mixed lobbying communication encourages direct lobbying, but only indirectly encourages grass-roots lobbying, then the entire costs of the communication are allocated based on the proportion of members and nonmembers receiving the communication.

Disclosure of lobbying expenditures

An electing charity must disclose lobbying expenditures annually on Schedule A of Form 990. In order to meet disclosure requirements, electing charities are required to keep detailed records of direct and grass-roots lobbying expenditures. Required records of grass-roots expenditures include: (1) all amounts directly paid or incurred for grass-roots lobbying; (2) payments to other organizations earmarked for grass-roots lobbying; (3) fees and expenses paid for grass-roots lobbying; (4) the printing, mailing, and other costs of reproducing and distributing materials used in grass-roots lobbying; (5) the portion of amounts paid or incurred as current or deferred compensation for an employee's grass-roots lobbying services; (6) any amount paid for out-of-pocket expenditures incurred on behalf of the electing charity for grass-roots lobbying; (7) the allocable portion of administrative, overhead and other general expenditures attributable to grass-roots lobbying; and (8) expenditures for grass-roots lobbying of a controlled organization.[93]

Description of Proposal

The proposal eliminates the separate limitation for grass-roots lobbying expenditures applicable to electing charities. Electing charities remain subject to the overall limitation on lobbying expenditures, which does not change in amount, but electing charities are not required to limit grass roots expenditures as a percentage of overall lobbying. Thus, an electing charity is able to make tax-free any combination of grass-roots and direct lobbying expenditures up to the lobbying non-taxable amount and does not risk loss of tax-exemption as a result of such expenditures until total lobbying expenditures normally exceed the lobbying ceiling amount. For purposes of the section 501(h) election, electing charities are not required to distinguish between grass-roots lobbying and direct lobbying, whether for mixed lobbying expenditures or otherwise.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2003.

[93] *See* Treas. Reg. sec. 56.4911-6.

G. Pilot Project for Forest Conservation Activities

Present Law

Tax-exempt bonds

In general

Interest on debt incurred by States or local governments is excluded from income if the proceeds of the borrowing are used to carry out governmental functions of those entities or the debt is repaid with governmental funds (section 103). Interest on bonds that nominally are issued by States or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such a private person, is taxable unless the purpose of the borrowing is approved specifically in the Code or in a non-Code provision of a revenue act. Such bonds are called "private activity bonds." The term "private person" includes the Federal Government and all other individuals and entities other than States or local governments.

Private activities eligible for financing with tax-exempt private activity bonds

Present law includes several exceptions permitting States or local governments to act as conduits providing tax-exempt financing for private activities. Both capital expenditures and limited working capital expenditures of charitable organizations described in section 501(c)(3) of the Code may be financed with tax-exempt bonds ("qualified 501(c)(3) bonds").

States or local governments may issue tax-exempt "exempt-facility bonds" to finance property for certain private businesses. Business facilities eligible for this financing include transportation (airports, ports, local mass commuting, and high speed intercity rail facilities); privately owned and/or privately operated public works facilities (sewage, solid waste disposal, local district heating or cooling, and hazardous waste disposal facilities); privately owned and/or operated low-income rental housing;[94] and certain private facilities for the local furnishing of electricity or gas. A further provision allows tax-exempt financing for "environmental enhancements of hydro-electric generating facilities." Tax-exempt financing also is authorized for capital expenditures for small manufacturing facilities and land and equipment for first-time farmers ("qualified small-issue bonds"), local redevelopment activities ("qualified redevelopment bonds"), and eligible empowerment zone and enterprise community businesses. Tax-exempt private activity bonds also may be issued to finance limited non-business purposes: certain student loans and mortgage loans for owner-occupied housing ("qualified mortgage bonds" and "qualified veterans' mortgage bonds").

With the exception of qualified 501(c)(3) bonds, private activity bonds may not be issued to finance working capital requirements of private businesses. In most cases, the aggregate volume of tax-exempt private activity bonds that may be issued in a State is restricted by annual volume limits.

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[94] Residential rental projects must satisfy low-income tenant occupancy requirements for a minimum period of 15 years.

Several additional restrictions apply to the issuance of tax-exempt bonds. First, private activity bonds (other than qualified 501(c)(3) bonds) may not be advance refunded. Governmental bonds and qualified 501(c)(3) bonds may be advance refunded one time. An advance refunding occurs when the refunded bonds are not retired within 90 days of issuance of the refunding bonds.

Issuance of private activity bonds is subject to restrictions on use of proceeds for the acquisition of land and existing property, use of proceeds to finance certain specified facilities (e.g., airplanes, skyboxes, other luxury boxes, health club facilities, gambling facilities, and liquor stores), and use of proceeds to pay costs of issuance (e.g., bond counsel and underwriter fees). Additionally, the term of the bonds generally may not exceed 120 percent of the economic life of the property being financed, and certain public approval requirements (similar to requirements that typically apply under State law to issuance of governmental debt) apply under Federal law to issuance of private activity bonds. Present law precludes substantial users of property financed with private activity bonds from owning the bonds to prevent their deducting tax-exempt interest paid to themselves. Finally, owners of most private-activity-bond-financed property are subject to special "change-in-use" penalties if the use of the bond-financed property changes to a use that is not eligible for tax-exempt financing while the bonds are outstanding.

Taxation of income from timber harvesting

In general, gross income for Federal income tax purposes means all income from whatever source derived, including gross income derived from a trade or business. An organization exempt from taxation generally is subject to tax on its unrelated business taxable income, generally defined to mean gross income (less deductions) derived from a trade or business, the conduct of which is not substantially related to the exercise or performance of the organization's exempt purposes or functions, that is regularly carried on by the organization. Special unrelated trade or business income rules applicable to the cutting of timber are contained in sections 512(b)(5) and 631. Under these rules, the determination of whether income derived from the cutting of timber constitutes unrelated trade or business income depends upon a variety of factors.

Description of Proposal

Overview

In general

The proposal establishes a pilot project for forest conservation activities by providing two types of tax benefits available to qualified organizations that acquire forest and forest lands for conservation management. First, the proposal provides for the treatment of qualified forest conservation bonds as exempt facility bonds within the meaning of section 142. Second, the proposal provides for the exclusion from gross income of income from certain timber harvesting activities conducted by a qualified organization on lands acquired with proceeds from qualified forest conservation bonds.

Qualified organizations

Under the proposal, an organization must be a qualified organization to be eligible for the tax-exempt financing benefit, and must be a qualified organization for whom qualified forest conservation bonds have been issued (and remain outstanding as tax-exempt bonds) to be eligible for the income exclusion. Under the proposal, a qualified organization means a nonprofit organization: (1) substantially all the activities of which are charitable, scientific, or educational, including acquiring, protecting, restoring, managing, and developing forest lands and other renewable resources for the long-term charitable, educational, scientific, and public benefit; (2) more than one half of the value of the property of which consists of forests and forest land acquired with the proceeds from qualified forest conservation bonds; (3) that periodically conducts educational programs designed to inform the public of environmentally sensitive forestry management and conservation techniques; (4) whose board satisfies certain board composition requirements designed to ensure that it represents public conservation interests;[95] (5) with governance provisions contained in its bylaws that provide a supermajority vote of at least two-thirds of the members of the board of directors is required to approve and amend the qualified organization's qualified conservation plan; and (6) that upon dissolution, its assets are required to be dedicated to an organization exempt from tax under section 501(c)(3) that is organized and operated for conservation purposes, or to a governmental unit.

Qualified forest conservation bonds

In general

The proposal creates a new category of tax-exempt bonds, the "qualified forest conservation bond." For purposes of the Code, qualified forest conservation bonds are treated as exempt facility bonds, and therefore, unless otherwise provided, are governed by the same rules as exempt facility bonds. A qualified forest conservation bond means any bond issued as part of an issue if: (1) 95 percent or more of the net proceeds of such issue are to be used for qualified project costs; (2) such bond is an obligation of the State of Washington or any political subdivision thereof; and (3) such bond is issued for a qualified organization before December 31, 2006. The maximum aggregate face amount of bonds that may be issued under the pilot program is $250 million.

Qualified project costs

Qualified project costs include the cost of acquisition by the qualified organization, from an unrelated person, of forests and forest land located in the State of Washington that at the time of acquisition or immediately thereafter are subject to a conservation restriction that meets

[95] The proposal requires that at least 20 percent of the board members be comprised of representatives of the holders of the conservation restriction, and that at least 20 percent of the board members be public officials. Not more than one-third of the board members may be comprised of individuals who have or had (during a prescribed five year period) certain types of financial or contractual relationships with a commercial forest products enterprise.

certain requirements.[96] Qualified project costs also include interest on the qualified forest conservation bonds for the three-year period beginning on the date of issuance of such bonds, and credit enhancement fees that constitute qualified guarantee fees within the meaning of section 148. The conservation restriction must: (1) be granted in perpetuity to an unrelated charitable organization (other than a private foundation) that is organized and operated for conservation purposes, or to a governmental unit; (2) protect a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem, or preserve open space (including farmland and forest land) pursuant to a clearly delineated Federal, State, or local governmental conservation policy and yield a significant public benefit; (3) obligate the qualified organization to pay the costs incurred by the holder of the conservation restriction in monitoring compliance with such restriction; and (4) require that an increasing level of conservation benefits be provided whenever circumstances allow it.

Special rules

Subject to the following exceptions and modifications, issuance of qualified forest conservation bonds is subject to the general rules applicable to issuance of exempt-facility private activity bonds:

(1) Issuance of the bonds is not subject to the aggregate annual State private activity bond volume limits (section 146);

(2) The restrictions on acquisition of land and existing property do not apply (section 147(c) and (d));

(3) For purposes of section 147(b) (relating to the rule that maturity may not exceed 120 percent of economic life) the land and standing timber acquired with the proceeds of the bonds is treated as having an economic life of 35 years; and

(4) Interest on the bonds is not a preference item for purposes of the alternative minimum tax preference for private activity bond interest (section 57(a)(5)).

Qualified forest conservation bonds may be currently refunded if certain requirements are satisfied, but may not be advance refunded.

[96] For this purpose, a person is related to another person if such person bears a relationship to such other person described in section 267(b) (determined without regard to paragraph (9) thereof), or section 707(b)(1), determined by substituting 25 percent for 50 percent for purposes of those determinations. If such other person is a nonprofit organization, a person is related to such nonprofit organization if such person controls directly or indirectly more than 25 percent of the governing body of such nonprofit organization.

Exclusion of certain qualified harvesting activity income from tax

Income from qualified harvesting activities

Under the proposal, income, gains, deductions, losses, or credits from a qualified harvesting activity conducted by a qualified organization generally are not subject to tax or taken into account for Federal income tax purposes. A qualified harvesting activity means the sale, lease, or harvesting of standing timber: (1) on land owned by a qualified organization that it acquired with proceeds of qualified forest conservation bonds; and (2) pursuant to a qualified conservation plan adopted by the organization. Qualified harvesting activity does not include any sale, lease, or harvesting for any period during which the organization ceases to qualify as a qualified organization.

Timber cutting and the sale or lease of timber is not a qualified harvesting activity to the extent the timber harvesting or removal exceeds prescribed limits. For this purpose, the average annual area of timber harvested cannot exceed 2.5 percent of the total area of the land acquired with the proceeds of qualified forest conservation bonds. Further, the quantity of timber removed from such land cannot exceed the quantity that can be removed from such land annually in perpetuity on a sustained-yield basis determined only with respect to such land. Certain deviations from these restrictions are permitted to protect the forest from catastrophic danger, such as by fire or windthrow, or from imminent danger from insect or disease attack.

The amount of income from a qualified harvesting activity that may be excluded from gross income for a taxable year may not exceed the amount used by the qualified organization to make debt service payments during such taxable year for qualified forest conservation bonds.[97] The exclusion of income from a qualified harvesting activity does not apply during any period the organization fails to qualify as a qualified organization, or after the bonds are no longer outstanding or fail to qualify as tax-exempt bonds.

Qualified conservation plan

A qualified conservation plan means a multiple land use plan (a) designed and administered primarily for the purposes of protecting and enhancing wildlife, fish, timber, scenic attributes, recreation, and soil and water quality of the forest and forest land, (b) mandates that conservation of the forest and forest land is the single-most significant use of the forest and land, and (c) requires that timber harvesting be consistent with (1) restoring and maintaining reference conditions for the region's ecotype (such as with respect to types of trees), (2) restoring and maintaining a representative sample of young, mid, and late successional forest age classes, (3) maintaining or restoring the resources' ecological health for purposes of preventing damage from fire, insect, or disease, (4) maintaining or enhancing wildlife or fish habitat, or (5) enhancing research opportunities in sustainable renewable resource uses.

[97] This debt service limitation does not apply to income that otherwise is not subject to tax under other provisions of the Code (e.g., income from harvesting if such harvesting activity is not an unrelated trade or business within the meaning of section 513 with respect to the qualified organization).

Recapture taxes

Once the qualified forest conservation bonds issued for a qualified organization are no longer outstanding or cease to qualify as tax-exempt bonds, the qualified organization becomes liable for a recapture of tax benefits (plus interest) for its excess harvesting activities. Under the provision, if the average annual area of timber harvested from the land exceeds the applicable 2.5 percent average annual area limitation, the organization's income tax liability is increased by the amount of the tax benefits (plus interest) attributable to such excess harvesting.

Report on pilot project

The proposal provides that the Comptroller General of the United States shall conduct a study on the pilot project for forest conservation activities under the proposal. Such study shall examine the extent to which forests and forest lands were managed during the five year period beginning on the date of enactment of the proposal to achieve the goals of such project. Not later than six years after the date of enactment of the proposal, the Comptroller General shall submit a report of such study to the Committee on Ways and Means and the Committee on Resources of the House of Representatives and the Committee on Finance and the Committee on Energy and Natural Resources of the Senate.

Effective Date

The proposal is effective for obligations issued on or after the date of enactment.

III. OTHER PROVISIONS

A. Compassion Capital Fund

Present Law

There is no provision under present law. However, $35 million was appropriated for such grants for fiscal year 2003, to be awarded by the Secretary of Health and Human Services under Section 1110 of the Social Security Act.

Description of Proposal

The provision creates a Secretary's Fund to support and replicate promising social service programs as part of the Social Security Act. Grants would be awarded by the Secretary of Health and Human Services to support any private entity that operates a promising social services program. These entities would then use these funds to provide technical assistance, such as legal assistance or business assistance, or to provide support to other entities that operate social service programs that assist persons and families in need.

Up to 25 percent of the funds appropriated also could be used by the Secretary of Health and Human Services to provide guidance and technical assistance on program implementation to States and political subdivisions of States.

The provision authorizes $150 million for fiscal year 2004 and such sums as may be necessary for fiscal year 2005 through fiscal year 2008.

Effective Date

The proposal is effective on the date of enactment.

B. Individual Development Accounts

Present Law

The Assets for Independence Act[98] authorizes $25 million annually for a five-year demonstration Individual Development Account ("IDA") program to evaluate the effects of savings incentives on persons of limited means. Means tested programs must disregard all funds in an IDA, including accruing interest, in determining an individual's eligibility. The demonstration program provides direct Federal funds to nonprofit organizations, States and localities, tribal governments, community-development financial institutions, and certain credit unions to match the amount of earnings deposited by eligible individuals. Grantees must provide non-Federal matching funds (one dollar per Federal grant dollar), and the maximum Federal grant is $1 million for each project year. Eligible persons are those (1) who are eligible under the Temporary Assistance for Needy Families program, or (2) whose household net worth is below $10,000 ("net worth test"), and who meet the greater of (a) the income limits of the earned income credit (taking into account the size of the household)[99] or (b) 200 percent of the poverty guideline ("income test").

Each participant is eligible to receive up to $2,000 in Federal funds plus accrued interest while they participate over the course of the project. Households may receive no more than $4,000 in Federal grant funds over the course of the project. The projects must create trust or custodial accounts that permit withdrawals of account balances only for three designated purposes: (1) first home purchase, (2) business capitalization, and (3) postsecondary education. Emergency withdrawals (from the account holder's own deposits only) are allowed for three conditions--medical expenses, prevention of eviction or mortgage foreclosure, and living expenses after job losses.

Each grantee is required to prepare an annual report on the progress of its project. These reports must be submitted to the Secretary of Health and Human Services, and if a tribe, State or local government committed funds to the project, to the Treasurer (or equivalent official) of the State in which the project is conducted. The Secretary of Health and Human Services is required to provide the results of these reports to Congress every 12 months until all of the demonstration projects are completed, and to submit a final report, setting forth the results and findings of all reports and evaluations, not later than 12 months after the conclusion of all demonstration projects. The Assets for Independence Act directs the Secretary of Health and Human Services to enter into a contract with an independent research organization to evaluate the projects, individually, and as a group. The Secretary of Health and Human Services may spend up to $500,000 each fiscal year for evaluation expenses.

The demonstration program expires at the end of fiscal year 2003.

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[98] Title IV of Pub L. No. 105-285 (1998).

[99] Sec. 32(b)(2).

Description of Proposal

The proposal extends the program for an additional five years, through fiscal year 2008, continuing the current authorization of $25 million per year for the program.

The proposal also makes several technical changes designed to ease program administration: (1) removing the cost of financial literacy activities provided to IDA holders from the current administrative spending cap (current law bars entities from spending more than 15% of program dollars on administrative costs, including financial literacy activities); (2) making eligible certain households whose income does not exceed 50 percent of Area Median Income; (3) extending the availability of IDA funds for up to 6 months beyond program termination; (4) providing greater flexibility in how IDA funds can be spent for certain postsecondary expenses; and (5) providing grantees added flexibility in spending excess interest earned on IDA match funds.

Effective Date

The proposal is effective for fiscal years 2004 through 2008.

C. Maternity Group Homes

Present Law

Part B of the Runaway and Homeless Youth Act authorizes the Secretary of Health and Human Services to make grants to public and nonprofit private agencies to establish and operate Transitional Living Projects for homeless youth. Grantees provide both services and shelter, such as group homes, host family homes, and supervised apartments, for homeless youth. Of funds appropriated for all components of the Runaway and Homeless Youth Act (except the Sexual Abuse Prevention Program under Part E), the Secretary must use no less than 90 percent for Runaway and Homeless Youth centers and services under Part A and Transitional Living Project grants under Part B. Further, of this 90 percent, no less than 20 percent or more than 30 percent must be reserved for Transitional Living Project grants under Part B.

Description of Proposal

The proposal would add "maternity group homes" to the illustrative list of types of shelter that can be supported through Transitional Living Project grants. The proposal also defines "maternity group homes" to mean community-based, adult-supervised group homes that provide young mothers and their children with a supportive and supervised living arrangement in which the mothers are required to learn parenting and other skills to promote their long-term economic independence and the well-being of their children, and that provide pregnant women with information about the option of placing their children for adoption, assistance with prenatal care and child birthing, and pre- and post-placement adoption counseling.

The proposal requires the Secretary to contract for an evaluation of maternity group homes. The proposal also authorizes appropriations of $33 million in fiscal year 2003 and such sums as necessary for fiscal year 2004 for maternity group homes. This authorization would be separate from the present law authorization of appropriations for Transitional Living Projects and other components of the Runaway and Homeless Youth Act.

Effective Date

The proposal is effective for fiscal years 2003 and 2004.