



## **Excess Business Holdings**

Under the Pension Protection Act of 2006 (PPA), the private foundation excess business holdings rule apply to donor-advised funds as if they were private foundations.<sup>1</sup> That is, the holdings of a donor-advised fund in a business enterprise, together with the holdings of persons who are disqualified persons with respect to that fund, may not exceed any of the following:

- Twenty percent<sup>2</sup> of the voting stock<sup>3</sup> of an incorporated business
- Twenty percent of the profits interest of a partnership or joint venture or the beneficial interest of a trust or similar entity

Ownership of unincorporated businesses that are not substantially related to the fund's purposes is also prohibited.

Donor-advised funds receiving gifts of interests in a business enterprise after the date of the PPA's enactment (August 17, 2006) will have five years to divest holdings that are above the permitted amount, with the possibility of an additional five years if approved by the Secretary of the Treasury. Funds that currently hold such assets will have a much longer period to divest under the same complicated transition relief given to private foundations in 1969.<sup>4</sup>

### **What is a donor-advised fund?**

See [What is a Donor-Advised Fund?](#) on the Council's website.

### **What is a business enterprise?**

A "business enterprise" is the active conduct of a trade or business, including any activity which is regularly carried on for the production of income from the sale of goods or the performance of services. Specifically excluded from the definition are:

- Holdings that take the form of bonds or other debt instruments unless they are a disguised form of equity
- Income from dividends, interest, royalties and from the sale of capital assets
- Income from leases unless the income would be taxed as unrelated business income

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<sup>1</sup> The language is clear that it is only the donor-advised fund—not the sponsoring charity—that is to be treated as a private foundation. Accordingly, it appears that this section does not apply to assets held by the sponsoring charity's investment pools, or assets held by funds that are not donor-advised.

<sup>2</sup> Thirty-five percent if it can be shown that persons who are not disqualified persons have effective control of the business.

<sup>3</sup> Additionally, the donor-advised fund will be barred from holding non-voting stock of an incorporated business unless the disqualified persons collectively own less than 20 percent of the voting stock.

<sup>4</sup> Excess holdings acquired by purchase must be disposed of immediately. If purchases by disqualified persons cause the donor-advised fund to have excess holdings, the donor-advised fund will have 90 days to dispose of the excess.

- “Functionally-related” businesses and program-related investments
- Businesses that derive at least 95 percent of their income from passive sources (dividends, interest, rent, royalties, capital gains). This will have the effect of excluding gifts of interests in most family limited partnerships, and other types of holding company arrangements.

### **What is a disqualified person?**

Donors and persons appointed or designated by donors are disqualified persons if they have—or reasonably expect to have—advisory privileges with respect to the donor-advised fund by virtue of their status as donors. Members of donors’ and advisors’ families are also disqualified, but the section does not define “family” and does not cross-reference either section 4958 or 4946 for the definition. Finally, the term includes 35-percent-controlled entities as defined in section 4958(f)(3).

### **What contributions will be affected?**

The new rule will mainly affect contributions of closely-held businesses and in most cases will require the donor-advised fund to dispose of the contributed interest within five years of the date of gift because the disqualified persons will generally own more than 20 percent of the business.<sup>5</sup> The rule will not apply to assets held by the sponsoring charity—as long as they are not held by the donor-advised fund—apparently permitting a sponsoring charity to keep a contributed asset as part of its overall investment portfolio. It will also not apply to gifts to funds—such as field-of-interest or designated funds—that are not donor-advised.

Because they are not “business enterprises,” the rule will not apply to most gifts of real property. The most important exception will be undeveloped land, which may become a business enterprise if the charity that owns it takes extensive steps to subdivide it and prepare it for sale. This is a particularly dangerous situation because this could require immediate divestiture. Interests in investment partnerships and LLCs—including family partnerships, hedge funds, REITs, and so forth—are excluded from the definition of business enterprise as long as 95 percent or more of the entity’s income is from passive sources. Examples of other property gifts that are excluded because they are not business enterprises include:

- Oil and gas interests (non-working)
- Life insurance
- Tangible personal property (as long as it is not inventory)
- Remainder interests in personal residences and farms

### **What about existing holdings?**

The rules that will apply to donor-advised funds holding business interests on the date of enactment of the PPA are quite complex. In Phase one, donor-advised funds that together with their disqualified persons hold more than a combined 50 percent interest in a business will be required to reduce their combined holdings to 50 percent, and, in most cases reduce the foundation’s share of the holdings to 25 percent. The time period for doing so is:

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<sup>5</sup> Under the *de minimis* rule, the donor-advised fund could continue to hold an interest that did not exceed two percent of the voting stock and two percent of the value.

- Twenty years if the donor-advised fund and disqualified persons collectively own 95 percent or more of the voting or profits interests of a business enterprise
- Fifteen years if the combined total is 75 percent or more, but less than 95 percent
- Ten years if the combined total is more than 50 percent, but less than 75 percent

Phase two is the 15-year period that begins at the end of phase one. During this period, the combined holdings are limited to 50 percent, but if the disqualified persons' share is two percent or more the foundation may own no more than 25 percent of the total. At the end of phase two, the combined holdings may not exceed 35 percent and the foundation's share may not be more than 25 percent if the disqualified persons' share is two percent or more.<sup>6</sup>

**When does this provision take effect?**

At the start of the first full tax year following the date of enactment (August 17, 2006)—January 1, 2007, for calendar-year taxpayers. Note that the transition rules for existing holdings will apply only to assets held on the date of enactment.

**DISCLAIMER**

The information provided in this booklet is based on our continuing analysis of the bill. Every effort has been made to ensure accuracy of these documents. Please understand, however, that due to the complexity of the bill and the fact that many of these provisions introduce issues that are new to the Internal Revenue Code, this information is subject to change. The information is not a substitute for expert legal, tax or other professional advice and we strongly encourage grantmakers and donors to work with their counsel to determine the impact of this legislation on their particular situations. This information may not be relied upon for the purposes of avoiding any penalties that may be imposed under the Internal Revenue Code.

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<sup>6</sup> Additional rules apply to cover situations such as mergers, redemptions, and acquisitions.