# CHARITABLE GIFTING AND THE CLOSELY HELD BUSINESS OWNER

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# WHY IS IT IMPORTANT?

- Closely held business owners are connected to their communities and typically their business life is integrated into that community.
- Many closely held business owners have a tradition of supporting their community philanthropically.
- Successful business owners want financial security and a legacy for themselves, their family and their businesses.
- Business owners can utilize cash, business assets and ownership interests to achieve financial and philanthropic goals.

# DISCUSSION POINTS

- Taxation and charitable gifting:
  - Income Tax
  - Gift Tax
  - Estate Tax
  - Valuation and Substantiation
  - Appraisals

# DISCUSSION POINTS -- CHOICE OF VEHICLE

- Donor-Advised Funds
- Funds at Community Foundation
- Supporting Organizations
- Private Foundations (Excise Taxes and Self-Dealing)
- Charitable Remainder Trusts
- Charitable Lead Trusts

# DISCUSSION POINTS – CLOSELY HELD BUSINESS

1. "S" Stock
2. Partnership or LLC Interests
3. "C" Stock
4. "C" Corporation Bailout
5. Charitable Gifting by "S" Corp, "C" Corp, Partnerships and LLCs
6. Debt-Financed Assets

# DISCUSSION POINTS – CLOSELY HELD BUSINESS

Tying it all together: Examples of success.

## Income Tax – Deductions – Individuals

- Maximum amount of a donor's income tax deduction depends upon the donor's income. IRC Section 170
- Amount of deduction depends on the type of property contributed (ordinary income or long-term capital gain), the nature of the charitable entity (private or public), and the amount of the donor's adjusted gross income (AGI), on the donor's income tax return. IRC Section 170(b)
- Amounts that cannot be deducted in one year can be carried over for five years, then deduction expires. IRC Section 170(d)(1)(A).

# TAXATION AND CHARITABLE GIFTING

## Income Tax – Deductions – Individuals

- Gifts of ordinary income property or short-term capital gain property is usually limited to basis (and generally not tax favored). IRC Section 170(b).
- An exception is personal property with Section 1245 recapture potential (as long as it is a bona fide business). Treas. Reg. Section 1.170A-4(d) Ex 2.
- Generally, depreciated property should be sold and proceeds given to charity, rather than a direct charitable gift, so that a Section 165 loss deduction can be preserved.

# TAXATION AND CHARITABLE GIFTING -- INDIVIDUALS

- Gifts to public organizations are generally more tax favorable than gifts to private foundations.
- Gifts to a public charity, if cash or ordinary income property, are limited to 50% of AGI; if capital gain property, are limited to 30% of AGI (IRC sections 170(b)(1)(C) and 170 (b)(1)(D).
- Gifts to private non-operating foundations, if cash or ordinary income property, are limited to 30% of AGI;  if capital gain property are limited to 20% of AGI.
- Gifts to a private operating foundation, if cash or ordinary income property are limited to 50% of AGI or if capital gain property are limited to30% of AGI. IRC Section 170(b)(1)(B), (D)

# TAXATION AND CHARITABLE GIFTING – GIFT TAX

- IRC Section 2522 allows an unlimited gift tax deduction for lifetime transfers to qualifying recipients for public, charitable, religious, and other similar purposes.

- In essence, this deduction operates as an exclusion.

- For the most part, the rules are the same as those for the charitable deduction from the estate tax.

# TAXATION AND CHARITABLE GIFTING – VALUATION AND SUBSTANTIATION

- Non-cash charitable gifts are valued at “fair market value”.
- Donor has the burden of proof. (Welch. V. Helvering, 290 U.S. 111(1933).

# TAXATION AND CHARITABLE GIFTING – VALUATION AND SUBSTANTIATION – SPLIT INTEREST GIFTS

- If the gift is a split interest gift, actuarial values are used in valuation. Tables are in IRC Section 7520 (Treas.Reg. Section 1.7520).

- Actuarial values are based on (1) life expectancy of a designated individual or individuals (mortality component) and (2) assumed rate of return (the “interest rate component”. (See IRS Publication 1458 Actuarial Values).

# TAXATION AND CHARITABLE GIFTING – ESTATE TAX

- IRC Section 2055 allows an unlimited deduction from decedent's gross estate for bequests and other transfers to qualifying recipients for public, charitable, religious and other similar purposes.

- Deduction is reduced by amount of any death taxes that, either by terms of will or by local law, are assessed against an otherwise deductible bequest or transfer.

- Special rules apply for split interest gifts. To qualify, it must be a charitable remainder annuity trust, charitable remainder unitrust or pooled income fund. Income interest must be in the form of guaranteed annuity or must be a fixed percentage of FMV valued annually.

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- These requirements do not apply to a remainder interest in personal residence or farm, or to an undivided portion of a decedent’s entire interest.

# TAXATION AND CHARITABLE GIFTING – VALUATION AND SUBSTANTIATION – APPRAISALS

- Except when valuation of a charitable gift is straightforward (ex. cash, publicly traded stock) an appraisal is required.
- Rev. Procedure 66-49, 1966-2 C.B. 1257, modified by Rev. Proc. 96-15) sets forth the minimum that is required in the appraisal.
- There are additional “qualified appraisal” requirements for any gift over $5,000. If the gift is one of closely held stock, the threshold is $10,000. IRC Section 170(f)(11)(C) and Treas. Reg. Section 1.170A-13 (c)(2)(I).
- Penalty for noncompliance with appraisal rules is total disallowance of charitable deduction. IRC Section 170(f)(11)(G).

# TAXATION AND CHARITABLE GIFTING – VALUATION AND SUBSTANTIATION – APPRAISALS

Revenue Procedure 66-49 rules. Appraisal must include:

- Summary of appraiser's qualifications;
- Statement of the value and appraiser's definition of value concluded;
- Basis on which the appraisal was made, including any restrictions, understandings or covenants limiting use or disposition of property;
- Date as of which the property was valued; and
- Signature of the appraiser and the date the appraisal was made.

# TAXATION AND CHARITABLE GIFTING – VALUATION AND SUBSTANTIATION – APPRAISALS

Additional requirements if above threshold, the donor must:

- Obtain a qualified appraisal and attach a summary (For 8282) to his/her return.
- To be a qualified appraisal, the appraisal must be made not earlier than 60 days before the date of the contribution, the appraisal document must be prepaid, signed and dated by a qualified appraiser and generally the fee for the appraisal must not be based on a percentage of the appraised value.
- These rules apply to individuals, partnerships and corporations.

# TAXATION AND CHARITABLE GIFTING – VALUATION AND SUBSTANTIATION – APPRAISALS

- If value of over $500,000 is claimed, then the qualified appraisal itself must be attached to tax return. IRC Section 170(f)(11)(D).

- “Qualified appraiser” was revised by Pension Protection Act of 2006 (PPA 2006). Now there is a civil penalty under Section 6695A for any person who prepares an appraisal that results in a substantial or gross valuation misstatement in values.

- PPA also lowered threshold for overvaluation penalty.

# TAXATION AND CHARITABLE GIFTING – SUBSTANTIATION REQUIREMENTS

- A deduction is not allowed for any charitable contribution of $250 or more unless it is substantiated.

- This is a written contemporaneous acknowledgement of the contribution by the donee organization.

- Acknowledgement must include the amount of the cash and description (not value) of any property (other than cash) contributed.

- If donee provides any goods or services in consideration for the contribution, that must also be acknowledged with a good faith estimate of value.

# TAXATION AND CHARITABLE GIFTING – SUBSTANTIATION REQUIREMENTS

- Acknowledgement is considered contemporaneous if received on or before date the applicable tax return is filed or due date for the return (including extensions).

- For charitable gifts by S corporations or partnerships, the entity itself is treated as the taxpayer for substantiation purposes. (Therefore a shareholder or partner is not required to obtain additional substantiation for his or her share of contribution).

# TAXATION AND CHARITABLE GIFTING – SUBSTANTIATION REQUIREMENTS

- If property to which the qualified appraisal rules apply is sold or disposed of by charity within three years of contribution, the disposition (and proceeds, if any), must be reported to the Service and to donee on Form 8282.

# TYPES OF CHARITABLE ENTITIES – DONOR-ADVISED FUND

- Fund created by a public charity (and, therefore, more favorable tax deduction than if to private foundation).

- Donor provides advice or recommendations concerning distributions from the fund; however, the charity must have ultimate control over the distribution decisions.

- Distributions may not be made to any individual or entity unless it is for a charitable purpose; penalties apply.

# TYPES OF CHARITABLE ENTITIES – DONOR- ADVISED FUND

- Permitted distributions to any charitable organization described in IRC Section 170(b)(1)(A) other than a ("disqualified support organization").

- Permitted distributions also include the public sponsoring organization of donor-advised fund and other donor-advised funds.

# TYPES OF CHARITABLE ENTITIES -- FUND AT A COMMUNITY FOUNDATION

- Creating a fund at a community foundation incorporates the tax advantages of gift to a public charity and the individual nature of a private foundation.
- Very flexible.
- Donor can establish an unrestricted fund (addressing the changing needs of the community over time) or a field of interest fund (such as supporting the arts), a designated fund (specific charity), or a donor-advised fund.
- Deferred gifts are possible.

# TYPES OF CHARITABLE ENTITIES -- SUPPORTING ORGANIZATIONS

- A supporting organization is a public charity that need not be (and usually is not) publicly supported.
- It is connected to a public charity it supports. IRC Section 509(a)(3).
- Examples include religious organizations connected with churches, university presses, etc.
- Not subject to private foundation excise rules.
- Advantages over a private foundation include that stock in a closely held company are deductible to extent of 30% of donor’s contribution base.
- Can include a significant interest in a closely held business.
- Must not be controlled directly or indirectly by disqualified persons such as donors and family members.

# TYPES OF CHARITABLE ENTITIES -- SUPPORTING ORGANIZATIONS

- Transactions between the supporting organization and the donor, or related parties (including entities controlled by the donor), are permissible as long as they are arms length and reasonable (for example, a corporation controlled by the donor could redeem stock owned by a supporting organization).

- Supporting organization may purchase stock from donor's estate and may sell stock to members of donor's family.

# TYPES OF CHARITABLE ENTITIES -- SUPPORTING ORGANIZATIONS

- Supporting organization’s investment activities are less restrictive than those of a private foundation.

- Supporting organizations can accumulate income for a reasonable period for future charitable projects and there is no specific annual payout requirement.

# TYPES OF CHARITABLE ENTITIES -- PRIVATE FOUNDATION

- Benefits of a private foundation include independence, flexibility, a way to keep subsequent generations involved, and control over philanthropy.
- Typically funded from very few sources, such as an individual, or members of one family.
- Typical grants are to public charities and scholarships to individuals (although some run charitable programs).

# TYPES OF CHARITABLE ENTITIES -- PRIVATE FOUNDATION

- IRS Section 509 covers private foundations.
- A private foundation is a tax exempt charitable organization defined in 501(c)(3) which is NOT:
  - a 50 percent organization;
  - a publicly supported organization;
  - a satellite organization that is formed only to support an organization that is not a private foundation; or
  - An underwriters laboratory or public safety testing organization.

# TYPES OF CHARITABLE ENTITIES -- PRIVATE FOUNDATION

- Established as a non profit corporation or trust.
- No minimum requirement to establish; but administrative costs can be significant.
- Very few restrictions on who can be a foundation manager (trustees (if trust); directors and officers (if corporation)).
- A donor to a private foundation receives less generous deductions than a donor to a public charity.

# TYPES OF CHARITABLE ENTITIES -- PRIVATE FOUNDATION

- A private foundation must expend five percent of its net asset value each year for charitable and administrative purposes. Code Section 4942(e).

- Gifts to a private foundation may be made during lifetime or at death.

# TYPES OF CHARITABLE ENTITIES -- PRIVATE FOUNDATION

- Private foundations are subject to excise taxes. (These rules can also apply to Charitable Lead Trusts and sometimes Charitable Remainder Trusts).

- Excise taxes are found in IRC sections 4940-4948.

- Except for the IRC Section 4940 tax on net investment income, each of the penalty excise taxes are two level taxes: an initial tax and a more severe tax if the foundation fails to correct the violation that gives rise to the initial tax liability.

# TYPES OF CHARITABLE ENTITIES -- PRIVATE FOUNDATION

- Self-dealing transactions are prohibited under IRC Section 4941.
- Concept is financial transactions between private foundation and disqualified persons should be prohibited – even if the transaction benefits the private foundation.
- Self-dealing transactions include dealings between the foundation and its substantial contributors, foundation officials and related persons (“disqualified persons”- defined in IRC 4946(a).).

# TYPES OF CHARITABLE ENTITIES -- PRIVATE FOUNDATION

- Examples include selling or leasing property or making loans between foundation and disqualified person. There are some exceptions.
- IRC 4941(d)(2)(C) provides if goods, services or facilities are between a private foundation and a disqualified person and the foundation is the receiver, self-dealing does not apply if the use is exclusively for the foundation's charitable purposes.
- IRC 4941 (d)(2)(D) provides if the disqualified person is the receiver, it is not self-dealing if the terms of the deal are no more favorable than those on which they are made to the general public.

# TYPES OF CHARITABLE ENTITIES -- PRIVATE FOUNDATION

- IRC Section 4941(d)(2)(E) provides that payments for reimbursements or compensation by the foundation to a disqualified person do not constitute self-dealing if the services are reasonable and necessary to carrying out the foundation's exempt purposes.

# TYPES OF CHARITABLE ENTITIES -- PRIVATE FOUNDATION

- Section 4942 penalty if foundation does not make an annual minimum distribution equal to five percent of the investment assets. This tax is 30% of the amount of income undistributed at the beginning of the year.
- If not corrected within taxable period, the tax is 100%.
- Exception when amounts are set aside for a specific charitable project, even if not distributed – however, advance approval from IRS is required.

# TYPES OF CHARITABLE ENTITIES -- PRIVATE FOUNDATION

- Foundation excess business holdings tax of Section 4943 is intended to restrict foundation involvement in the ownership and operation of businesses.
- Excess occurs if (1) disqualified persons own 20% or more of the voting stock of incorporated businesses and (2) foundation owns at least 2% of the business.
- This is a two tier tax – tier one is 10% and tier two is 200%.
- Private foundation has five years to dispose of excess holdings and can obtain another five year extension for good cause.

# TYPES OF CHARITABLE ENTITIES -- PRIVATE FOUNDATION

- Section 4944 taxes investments that jeopardize the foundation's exempt purpose.

- Expenditures for non-charitable purposes include lobbying, propagandizing, influencing elections, conducting voter education, making grants to certain individuals (unless prior approval by IRS), and making grants for non-charitable purposes.

# TYPES OF CHARITABLE ENTITIES -- PRIVATE FOUNDATION

- Can be perpetual; if terminated, must be distributed or expended for its charitable purpose. Section 507 imposes termination tax which can be avoided with planning.
- Reporting requirements – federal annual Form 990-PF reporting assets and liabilities, taxable income and information regarding donations made and grants and expenditures.
- State reporting requirements vary.
- If in corporate form there are additional reporting and filing fees; to preserve corporate structure and liability corporate formalities (minutes, etc) should be maintained.

# TYPES OF CHARITABLE ENTITIES -- PRIVATE FOUNDATION

- When making gift or bequest of business to private foundation client should consider:

  A. Loss of control over business asset.

  B. Loss of income or revenue.

  C. Client no longer owns it, so cannot be gifted/bequeathed to family.

  D. Client no longer owns asset, so cannot used on financial statement for borrowing purposes.

  E. Client or heirs may be a disqualified person (IRC Section 4941), which limits voting; may require resigning from foundation board or interest and penalties on transactions between client and foundation.

  F. Foundation may incur UBTI on the income the asset generates (IRC section 512) which reduces tax benefit.

# TYPES OF CHARITABLE ENTITIES -- CHARITABLE REMAINDER TRUSTS

- An irrevocable trust that provides for annual payments to individuals.
- A donor contributes property to a trust and, in return, receives an annual distribution from the trust annuity for their lives.
- The annual distribution can be either a set amount (an “annuity trust”), or may fluctuate with the value of the trust assets (a “unitrust”).
- If a qualified CRT, it is tax exempt unless there is unrelated business taxable income (UBTI).

# TYPES OF CHARITABLE ENTITIES -- CHARITABLE REMAINDER TRUSTS

- Donor is taxed only on income paid out, not on income or gains in trust. IRC Section 664(b).

- To be a qualified CRT under IRC Section 664, the trust must:

  1. Pay out at least 5% to non-charitable beneficiaries (5% of annual value for CRUT; 5% of initial value for CRAT). IRC Section 664(d)(1)(A) and 664(d)(2)(A). (Hard to do in low interest times).

  2. Maximum pay out of 50% of trust to non-charitable beneficiaries (50% of annual value for CRUT; 50% of initial value for CRAT. IRC Sections 664(d)(1)(A) and (d)(2)(A).

# TYPES OF CHARITABLE ENTITIES -- CHARITABLE REMAINDER TRUSTS

3. Maximum term of CRT is life of donor or individual beneficiaries, or if term of years, up to 20 years. IRC Section 664(d)(1)(A), (d)(2)(A).

4. There must be 10 percent minimum benefit to charitable beneficiary. IRC Section 664(d)(1)(D) and (d)(2)(D) (because CRUT can receive additional funds must met for each contribution).

5. Exhaustion rule: A CRAT will not be qualified if there is more than a 5% chance the annuity will exhaust prior to donor's death and, therefore, charity will not receive anything. Rev. Rul. 77-374

# TYPES OF CHARITABLE ENTITIES -- CHARITABLE REMAINDER TRUSTS

- Donor is entitled to income tax deduction equal to the present value of the charitable remainder interest. IRC Section 170(e), (f)(2)(A).

- Deduction is limited to cost basis if charitable beneficiary is a private foundation. (IRC Section 170(e)(5)(B).

- If trust provides that charitable beneficiaries must be public deduction is limited to 30% of AGI for cash gifts (with five year carry forward), or 20% of AGI for gifts of long-term appreciated property (with five year carry forward).

# TYPES OF CHARITABLE ENTITIES -- CHARITABLE REMAINDER TRUSTS

- Capital gains tax is avoided when asset is sold by CRT.  IRC Section 664.
- If donor receives the income stream, the balance in trust at death is included in gross estate and is subject to charitable deduction under IRC Section 2055, so no estate tax.
- If someone other than donor receives the income stream, the value may be subject to gift or estate tax, and a portion will be offset by charitable deduction. IRC Section 2056.

# TYPES OF CHARITABLE ENTITIES -- CHARITABLE REMAINDER TRUSTS

- Note: if the business and real estate are separate, and the donor contributes the business to a CRT, payment of rent to the real estate entity may constitute self-dealing because the payment of rent by a CRT to a disqualified person is self-dealing. IRC Section 4941 (d)(1)(A) and Treas. Reg. Section 53.4941(d)-2(b)(1).

- A limited exception applies when rent is suspended.  Treas. Reg.  Section 53.4941(d)-2(b)(2).

- If the real estate is also transferred to the CRT, and rent continues to be paid, UBTI includes rent received by CRT from a controlled entity, so the problem remains. IRC Section 512(b)(13) and Treas. Reg. Section 1.512(b)-1(l).

# TYPES OF CHARITABLE ENTITIES -- CHARITABLE REMAINDER TRUSTS

- Assume the donors made a $100,000 contribution to a charitable remainder unitrust, making an annual distribution of 5% of the value of the trust assets.
  - The first year's distribution will be $5,000.
  - They will be entitled to an immediate charitable deduction of approximately $44,679 (the present value of the remainder interest in the trust).
  - Distributions to them will generally be taxed as ordinary income, capital gains income, or a return of principal, depending on how it was earned by the trust.
- At the death of the surviving spouse, the remaining trust property passes to the charity.

# TYPES OF CHARITABLE ENTITIES -- CHARITABLE REMAINDER TRUSTS

- A business owner client should think twice before considering a CRT if:

  A. Client is not philanthropically inclined.

  B. Asset is “S” corporation stock.

  C. If asset is debt-financed.

  D. If it is a low-interest rate time – unless he does not need the income.

  E. Has no other way to leave assets to family at his death.

  F. Needs asset on his financial statement.

# TYPES OF CHARITABLE ENTITIES -- CHARITABLE REMAINDER TRUSTS

- Before embarking, be aware:

  A. Step Transaction Rule.

  B. Asset must be appraised to obtain income tax deduction (and cost could be significant).

  C. Review corporate documents -- can the stock be transferred, or is permission of company, or other stockholders needed?

  D. Client must give up voting control: if retained in a non-fiduciary capacity, donor is treated as owner of the stock and trust is a disqualified. CRT. IRC Section 675(4)(A).

# CHARITABLE PLANNING AND THE CLOSELY HELD BUSINESS – BUSINESS ASSETS NOT TO TRANSFER TO CRT

1. S corporation stock (not valid S owner): if client wishes to transfer S stock to CRT, may be wise to affirmatively terminate "S" status prior to transfer so all shareholders know "S" is terminated.

2. Partnership and LLC interests (UBTI).

3. Encumbered real estate.

# TYPES OF CHARITABLE ENTITIES -- CHARITABLE LEAD TRUSTS

- With a charitable lead trust, the charity receives the annual distribution from the trust each year, and at the termination of the trust, the donor’s family receives the balance, estate and gift tax-free.

- The annual distribution can be either a set amount (an “annuity trust”) or may fluctuate with the value of the trust assets (a “unitrust”).

- A CLT may be set up lifetime or at death.

- It is not exempt from federal income tax – and manner in which it is taxed depends on whether it is a grantor CLT or non-grantor CLT.  Taxed as complex trust but is entitled to deduction for payments to charities. IRC Section 642(c).

# TYPES OF CHARITABLE ENTITIES -- CHARITABLE LEAD TRUSTS

- Main reason wealthy donors use a CLT is estate tax savings, not income tax savings, as unlikely would be a grantor trust and, therefore, achieve an income tax deduction.

- There is a gift or estate tax deduction for value, which passes to charity and trust property, and any appreciation are removed from client's estate (unless client has retained powers that will bring it back in under IRC Sections 2036 or 2038).

- A CLT is an irrevocable trust.

# TYPES OF CHARITABLE ENTITIES -- CHARITABLE LEAD TRUSTS

- Donor has made a taxable gift to remainder beneficiaries equal to value of assets in trust, less the charitable component. Value of the charity's interest in the CLT is determined by the IRC Section 7520 rate, which is published monthly. If the remainder interest appreciates more than the 7520 rate, family receives benefit as appreciation exceeds the reported taxable gift.

- No gift tax annual exclusion is allowed because it is a gift of a future interest. IRC Section 2503(b).

# TYPES OF CHARITABLE ENTITIES -- CHARITABLE LEAD TRUSTS

- Unlike a CRT, there is no 20 year maximum term; for a CLT, there is no minimum or maximum payout requirement and no limitation on the number of years the annuity can be paid to charity. Treas.Reg. Section 1.337(d)(4)(c)(2).

- The CLT term can be measured by: (1) years, (2) the life or lives of individuals living when CLT is created, (3) a measuring life plus a term of years or (4) the shorter of a term of years, or a measuring life plus a term of years. IRC Section 170(f)(2)(B) and Treas. Reg. Section 1.170A-6(c)(2)(i)(A).

# TYPES OF CHARITABLE ENTITIES -- CHARITABLE LEAD TRUSTS

- Business owner may wish to establish a testamentary CLT and bequeath stock to it.
- Donor's estate would receive charitable deduction which eases estate tax burden.
- Disadvantages include possible excise tax issues, losing control of the stock, and making sure cash flow will occur to satisfy charitable obligations.

# TYPES OF CHARITABLE ENTITIES -- CHARITABLE LEAD TRUSTS

- Assume a donor would like to fund an Charitable Lead Annuity Trust with $500,000 that will pay the charity $25,000 per year for 20 years.
- Depending on how the trust is drafted, the donor may be able to take an income tax deduction for the present value of the annuity paid to the charity.

# TYPES OF CHARITABLE ENTITIES -- CHARITABLE LEAD TRUSTS

- The donor will have made a taxable gift of approximately $91,000 (the value of the remainder interest in the trust).
  - The taxable gift is calculated based upon a prescribed rate from the IRS. Those rates are currently very low (approximately 2%). If the trust income and capital appreciation exceeds the prescribed rate, then the donor's family will benefit.
  - In this example, if income and appreciation totals 8% per year, the donor's family will receive approximately $1,200,000 tax-free at the termination of the trust.

# TYPES OF CHARITABLE ENTITIES - CHARITABLE LEAD TRUSTS

- A CLT may make sense for a client who:

  A. Has philanthropic intent, would like to embark on an annual gifting program, and wants recognition.

  B. Has excess income (beyond need).

  C. Has exhausted income tax gifting deduction limits of IRC Section 170(c).

  D. Has a taxable estate and wishes to gift a significant amount to non-charitable beneficiaries for minimal gift tax cost.

# TYPES OF CHARITABLE ENTITIES - CHARITABLE LEAD TRUSTS

- A CLT may not make sense for a client who:

  A. Has no philanthropic intent or is not interested in embarking on an annual gifting program.

  B. Does not have excess income.

  C. Does not have a taxable estate and/or does not wish to gift a significant amount to non-charitable beneficiaries.

# TYPES OF CHARITABLE ENTITIES -- THOUGHTS ON CHARITABLE REMAINDER AND LEAD TRUSTS

- Charitable Remainder Trusts are more effective as interest rates rise since that is how the payout to the donor is determined.
- Charitable Lead Trusts are more effective as interest rates are low, since that will determine how much will pass tax-free to the donor’s family at the termination of the trust.

# TYPES OF CHARITABLE ENTITIES -- THOUGHTS ON CHARITABLE REMAINDER AND LEAD TRUSTS

- Charitable Remainder Trusts (and charitable gift annuities) can be viewed largely as a method to provide a reliable stream of income to the donor while ultimately benefiting charity.

- Charitable Lead Trusts can be viewed largely as a method for immediately benefiting charity while ultimately transferring wealth to future generations.

# CHARITABLE PLANNING AND THE CLOSELY HELD BUSINESS

- If the business owner is contemplating a charitable gift, a key factor to consider is if the gift should be made by the owner or the business entity itself.
- If Donor is making the gift, review all organizational documents and state law to make sure gift is allowed (corporate by-laws, LLC operating agreements, shareholder agreements, minutes, loan covenants etc.).
- Understand that an appraisal of the gifted asset is mandatory.

# CHARITABLE PLANNING AND THE CLOSELY HELD BUSINESS - THE “S” CORPORATION

- If the business is an “S” corporation, an S corp may not claim a deduction for its charitable contributions (IRC 1363(b)(2).) The deduction passes through to the shareholders and can be used on their own tax returns to the extent of their basis.
- S corporations can now have charities as shareholders.
- However a Charitable Remainder Trust cannot be a shareholder of an “S” corporation – if that occurs “S” status is lost. (IRC Sections 1361(c)(2) and (6).

# CHARITABLE PLANNING AND THE CLOSELY HELD BUSINESS – "S" STOCK PITFALLS

- If S stock is gifted, the amount of the charitable deduction is reduced by any portion of the value of the stock that is attributable to appreciated assets owned by the S corporation that generate ordinary income on sale. In other words, the S stock owner may deduct only to the extent of basis in the stock plus any long-term gain and loans made by shareholder to corporation.

- The income tax deduction for a gift of "S" stock is less than the appraised value to reflect any ordinary income assets the S corporation might already have.

# CHARITABLE PLANNING AND THE CLOSELY HELD BUSINESS – "S" STOCK PITFALLS

- Under unrelated business taxable income rules, charity must pay its own tax on any income that flows to charity – the charity must pay UBTI on its share of passive income (such as interest or capital gains). UBTI is payable whether or not the corporation has made may cash or other distributions that may enable to pay the UBTI.

- Unlike partnerships or LLCs, S corporations are subject to UBTI on all income attributable to an S Corp, including interest, dividends, rent and capital gains.

# CHARITABLE PLANNING AND THE CLOSELY HELD BUSINESS – “S” STOCK PITFALLS

- Important to understand donor’s adjusted basis in “S” stock prior to making a gift so that any UBTI liability can be assessed.
- Charity should consider indemnity/distribution agreement as condition to gift.
- The charity must pay UBTI when shares are disposed of – unless all stock is sold to public company which terminates the “S” election.

# CHARITABLE PLANNING AND THE CLOSELY HELD BUSINESS – "S" STOCK PITFALLS

- It is important to run the numbers – the tax liability incurred by the charity can end up being greater than any tax liability the donor would incur if the donor sold the stock.

- Consider an asset (such as cash or appreciated property) gift by the corporation. The shareholder will deduct the corporation's gift since it flows through to the shareholders. The negatives of a gift from the shareholder do not apply – donor's income tax deduction is not reduced, and charity will generally not pay UBIT when it owns or sells a gift received from the corporation.

# CHARITABLE PLANNING AND THE CLOSELY HELD BUSINESS – THE LLC (OR PARTNERSHIP)

- Gifting to charity using an interest in an LLC is complicated.
- Individual member of an LLC or partnership can gift LLC or partnership units to charitable organization.
- LLCs themselves are complicated. Some clients wish to divest themselves of passive investment assets because of annual reporting delays, very high compliance costs, illiquidity, and valuation difficulties.

# CHARITABLE PLANNING AND THE CLOSELY HELD BUSINESS – THE LLC (OR PARTNERSHIP)

- Be sure to determine how the LLC is taxed -- as a partnership or a corporation. Under check the box Treas.Reg. 301.7701, an election could have been made to be taxed as a corporation, not partnership.
- Be sure to read partnership agreement to determine whose consent is needed for any transfer.
- Choices include: outright sale, sale proceeds, or gift/sale.
- Gain from the sale or exchange of a partnership asset is a gain from the sale of a capital asset (IRC Section 741).

# CHARITABLE PLANNING AND THE CLOSELY HELD BUSINESS – THE LLC (OR PARTNERSHIP)

- Generally, charitable deduction equals FMV less any ordinary income gain (unless gift is to private foundation in which deduction is less). IRC Section 170(e)(1) and Treas.Reg. Section 1.170A-1(c)(1).

- Important to determine the adjusted basis of the partnership interest.  Before passive loss limits are applied the recognition of any gain or loss deduction is limited to the partner’s adjusted basis and then the amount at risk. The partner’s liabilities are added to basis to determine adjusted basis of the interest. At risk addition is increased if partner is also personally liable. IRC Section 465

# CHARITABLE PLANNING AND THE CLOSELY HELD BUSINESS – THE LLC (OR PARTNERSHIP)

- IRC Section 751 “hot assets” may be included in the donor’s deduction only to the extent of his basis in the partnership. IRC Section 170(e).
- The client must give the charity his entire partnership interest, or an undivided portion of his partnership interest, to obtain the deduction.

# CHARITABLE PLANNING AND THE CLOSELY HELD BUSINESS – THE LLC (OR PARTNERSHIP)

- Gifts of an LLC interest to a charity have same reduction of value for ordinary income assets as S corporation does.
- Gifts of an LLC can have part gift/part sale consequences if the LLC has any liabilities.
- When LLC owner contributes an interest with liabilities to a charity, the transaction is bifurcated into a charitable contribution and deemed sale. The amount of the charitable contribution is equal to the amount by which the FMV of LLC owner's share of partnership assets exceeds partner's share of the liabilities. Rev.Rul. 60-352.

# CHARITABLE PLANNING AND THE CLOSELY HELD BUSINESS – THE LLC

- For deemed sale, part of the transaction the owner's percentage share of LLC liabilities on the gifted LLC interest is considered the amount realized on the deemed sale of the LLC interest.

- Donor's basis in LLC interest is prorated between portion deemed sold and portion deemed contributed-based on the FMV of each portion. Donor must recognize, as gain, the spread between the amount realized and basis prorated to deemed sale.

- See Treas. Reg. 1.170A-3(d), Ex 1 and TC Memo 1983-200).

# CHARITABLE PLANNING AND THE CLOSELY HELD BUSINESS – THE LLC

- If it is a bargain sale to a private foundation, it is self-dealing no matter what the amount paid is. Treas. Reg. Section 53.4941(d)-2(a)(1).
- IRC Section 1011(b) limits the amount of basis that may be allocated to the portion of the interest sold.
- Ordinary income and capital gain on a bargain sale must be allocated to the sale and gift portion. Treas. Reg. Section 1.170A-4(c)(3).

# CHARITABLE PLANNING AND THE CLOSELY HELD BUSINESS – THE LLC – POSSIBLE PITFALLS

- Charity will look out for tax on phantom income. See GCM 37731 and 37037. The LLC operating agreement should require the entity to make distributions in an amount sufficient to pay any UBTI.
- Capital assessments: Typically a member in a LLC is liable for partnership debts and expenses only to the extent of their investment. The operating agreement can require members to make additional capital contributions or payments. Charitable entity should review this and other cash flow issues.
- Environmental liabilities: Charity should undertake due diligence before accepting real estate.
- Many charities will not accept gifts of LLC units because of concern it is not part of their charitable mission, and they will be at risk for liabilities.

# CHARITABLE PLANNING AND THE CLOSELY HELD BUSINESS – THE LLC (OR PARTNERSHIP)

- REMEMBER: Run the numbers before embarking.
  Make sure you know:
  - Adjusted basis.
  - At-risk amount.
  - Suspended passive losses.
  - IRC Section 751 hot assets that are attributable to the interest (such as unrealized receivables, certain inventory items and IRC Section 1245 and 1250 assets to the extent of recapture).
  - Share of partnership liabilities.
  - Knowledge of FMV of interest (and any discounts).
  - Appraisal and transfer costs.

# CHARITABLE PLANNING AND THE CLOSELY HELD BUSINESS

Non-tax factors to consider:

- Do you want an “outsider” as a shareholder?
- Does charity want to hold an illiquid investment?
- If charity is going to hold the stock, should there be a buyout agreement in place that addresses control and governance issues?

# CHARITABLE PLANNING AND THE CLOSELY HELD BUSINESS

- If it is a “C” corporation, there are two separate tax paying entities involved – one tax on the income of the business and another tax on the distribution the owner receives.

- Do you have a client who is a “C” corp, has philanthropic intent, who would like to remove retained earnings without having them taxed again, and who would like to maintain a controlling position in the company stock?

- Explore the “C” corporate charitable bailout.

# CHARITABLE PLANNING AND THE CLOSELY HELD BUSINESS – THE “C” CORP REDEMPTION BAILOUT

- A charitable bailout can help the donor achieve his charitable objectives, avoid capital gains tax, avoid long-term reduction in owner’s ownership position in a “C” corporation and allow tax-free distribution of excess cash accumulated in the C corporation.

- The donor gifts the C corporation stock to charity and then redeems the donated stock.

# CHARITABLE PLANNING AND THE CLOSELY HELD BUSINESS – THE “C” CORP REDEMPTION BAILOUT

- If donated to public charity and held for more than one year, donor may deduct at FMV; if not, to public charity – deduction is limited to basis.
- If the charity is a private foundation or CRT, normally a redemption would violate self-dealing, but there is a “corporate adjustment” exception that permits redemptions in certain cases.
- Donor avoids any built-in capital gains tax on donated stock, and corporation has bailed out its accumulated tax.
- Capital gain accruing to charity is passive income and exempt from UBTI.

# CHARITABLE PLANNING AND THE CLOSELY HELD BUSINESS – THE “C” CORP REDEMPTION BAILOUT

- Possible pitfall: Imputed pre-arranged sale.

- Rev. Rul. 78-197. If a stockholder contributes stock in an arrangement in which the charity is compelled to sell the stock, the IRS could take the position the shareholder has assigned the sale proceeds to the charity and tax the transaction as if the stock was sold or proceeds distributed to stockholder. This Rev. Rul. states redemption proceeds are taxable to individual stockholder only if the CHARITABLE entity is legally bound or can be compelled by corporation to surrender its shares for redemption.

- Important to remember:  legally the sale has occurred; it is just the tax consequences that affected. The asset is gone.

# CHARITABLE PLANNING AND THE CLOSELY HELD BUSINESS – THE “C” CORP REDEMPTION BAILOUT

- Redemption should not be for a note: Even though the redemption is exempt from the self-dealing rules, the note may trigger self-dealing under IRC Section 4941(d)(1)(B).

# CHARITABLE PLANNING AND THE CLOSELY HELD BUSINESS – THE "C" CORP REDEMPTION BAILOUT

- Possible pitfall: self-dealing and conflict of interest.
- Look at state law and also the conflict of interest policy for the charitable organization.
- Donor advised funds, private foundations and supporting organizations must be mindful of the excess business holdings prohibition and tax. This does not apply to public charities.

# CHARITABLE PLANNING AND THE CLOSELY HELD BUSINESS – THE PROBLEMS WITH DEBT-FINANCED ASSETS

- IRC 1011 (b). When a donor contributes debt-financed property, it is treated as a bargain/sale. Grantor is treated as having sold part of the asset for consideration equal to the debt and contributed the remainder. Grantor must then recognize gain on some part, or all, of the outstanding indebtedness. Basis is allocated pro rata between the two portions.

- Does not matter if debt is recourse or non-recourse.

- Does not matter if grantor continues to pay the debt after gift is complete.

# CHARITABLE PLANNING AND THE CLOSELY HELD BUSINESS -- EXAMPLE -- C CHARITABLE BAILOUT AND CRT

- Coupling the C corp charitable bailout and CRT for succession planning.
- Children should own shares of stock in corporation and business must have cash on hand (or be able to borrow from a bank).
- Parents transfer desired shares to CRT that parents are life beneficiaries of.
- Corporation redeems shares for cash (not a note).
- Corporation retires the shares and children's ownership in corporation increases.
- Remember this does not work for “S” corps.

# CHARITABLE PLANNING AND THE CLOSELY HELD BUSINESS -- EXAMPLE -- C CHARITABLE BAILOUT AND CRT

Remember when using a CRT for a business to consider:

- What is the asset (Stock, “S”, C” etc.) being transferred?
- What is the deduction?
- Is this a step transaction? Is there self-dealing?
- Is there UBTI (unrelated business taxable income)?
- Does the donor have philanthropic intent?

# CHARITABLE PLANNING AND THE CLOSELY HELD BUSINESS -- EXAMPLE -- USING A DISCLAIMER

- IRC Section 2518 provides that a beneficiary can make a qualified disclaimer of an asset.
- If the taker in default is a charitable organization (such as a private foundation or a donor-advised fund), this provides the beneficiary a “second look” at the estate plan and an ability to utilize the charitable deduction. (Note, however, that the disclaiming party cannot vote as a member of the board of the charitable organization, or on distributions from the charitable fund created with the disclaimed assets). See PLR 9320008.
- Disclaimer can be an asset, dollar amount or by formula.
- This can help with complex, tricky-to-value, assets.

# CHARITABLE PLANNING AND THE CLOSELY HELD BUSINESS -- EXAMPLE -- GIFT OF ASSETS OF S CORP TO CHARITY

- “S” corporation holds undeveloped land. No debt. Real estate was not held for sale and there is no depreciation recapture.

- Charitably inclined donor could distribute land to shareholders who would then contribute it to charity; but this causes recognized gain allocable to shareholders.

- Alternative: Corporation distributes land directly to charity (or community foundation for benefit of donor-advised fund). Deduction (limited to basis, plus loans) is allocated among shareholders. Can carry forward five years. Basis in stock reduced by deduction. Charity can sell land.

# CHARITABLE PLANNING AND THE CLOSELY HELD BUSINESS -- EXAMPLE -- GIFT OF FAMILY LIMITED PARTNERSHIP TO FAMILY FOUNDATION

- Parents own general partner share and part of limited units. Children own remaining units.
- Partnership owns real estate. No debt.
- For rental property, there had been accelerated depreciation so not advisable to gift as there will be depreciation recapture.
- Partnership selects undeveloped land (which has appreciated) to gift to private foundation.

# CHARITABLE PLANNING AND THE CLOSELY HELD BUSINESS -- EXAMPLE -- GIFT OF FAMILY LIMITED PARTNERSHIP TO FAMILY FOUNDATION

- Value of gift is reduced by long-term gain.
- All partners receive pro rata charitable income tax deduction (and carry forward five years, if needed).
- Donor's tax basis in partnership interest is reduced by his/her share of partnership basis in real estate.
- Foundation later sells real estate. No capital gain.
- Family manages foundation.

# CHARITABLE PLANNING AND THE CLOSELY HELD BUSINESS -- EXAMPLE -- GIFT OF "C" CORP TO CRT COUPLED WITH ILIT

- Grantor and children own stock in "C" corp.
- Grantor establishes a CRT and transfers his stock to it.
- Obtains qualified appraisal.
- Corporation redeems stock for cash. Trust receives cash – no capital gain.
- Self-dealing, excise tax avoided because all shares offered the same redemption terms.
- Post redemption, children own corporation.
- Grantor establishes ILIT to replace the wealth that will pass to charity, not children at his death.

# CHARITABLE PLANNING AND THE CLOSELY HELD BUSINESS -- EXAMPLE -- OUTRIGHT GIFT OF STOCK

- Sometimes simple is the best.
- Outright gift of stock to a charitable organization.
- Example: Dr. Doble in Massachusetts established an estate plan by which, at his death 40 years ago, a trust holding 87% of his stock benefited friends and key employees of his company. Upon its recent termination, Tufts University and Lesley University (the two vested beneficial owners) split $272 million.

# CHARITABLE PLANNING AND THE CLOSELY HELD BUSINESS -- EXAMPLE - GIFT OF STOCK TO PF

- Donor bequeaths stock at death to family foundation.
- Qualifies for charitable estate tax deduction (and, therefore, no estate tax on it).
- Family can no longer control stock because of excess business holdings rule, if held for more than 5 years (or extended time frame).
- Self-dealing excise tax may apply if stock is sold to disqualified person.

# CHARITABLE PLANNING AND THE CLOSELY HELD BUSINESS -- EXAMPLE - GIFT OF STOCK TO PF

- Indirect self-dealing (and self-dealing excise tax) may apply if combined holdings of foundation and disqualified persons exceed 50% of voting control; could create significant issues for everyday business transactions – leasing, renting, etc. and trigger excise tax.

- UBTI may apply until business is sold.

- If S corp, UBTI issues exacerbated.

- Alternative:  give to family members to buy from ESTATE not foundation.  Asset passing to foundation will be cash.

# CHARITABLE PLANNING AND THE CLOSELY HELD BUSINESS – SUMMARY

- Thinking about the disposition of a business asset is one of the most important decisions a business owner will ever have.
- This is typically coupled with a major life event – retirement, succession, disability, death, sale.
- The issues surrounding these issues are complex – both technically and psychologically.
- A strong multidiscipline advisor team is important.