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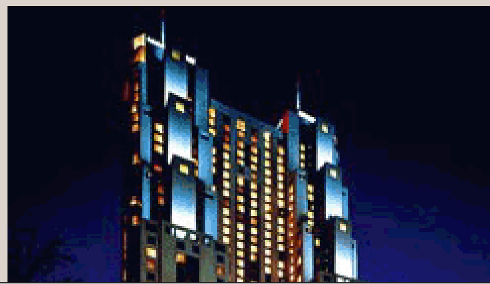

Conference Presentation Paper

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2011 National Conference on Philanthropic Planning

Using Charitable Strategies with Family Business Succession Planning

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I. Scope of Presentation

Owners of family-owned businesses represent a significant percentage of our country's most philanthropic individuals. One of the chief concerns facing family business owners is how to achieve an orderly and affordable transfer of the business to the next generation and/or key employees. In other words, the concern is how to keep the family business in the family. Failure to properly plan for a smooth transition can result in monetary losses and even the loss of the business itself. It is estimated that more than 70% of family-owned businesses do not survive the transition from founder to second generation. However, given adequate time and proper planning, a business succession plan can be implemented easily and often profitably. For those who are already charitably inclined, business exit planning using charitable strategies allows them to add an additional goal: doing good things for their favorite charity or their community and, at the same time, securing significant tax and estate benefits.

Business succession planning and charitable giving are very complex matters—far more complex than can be thoroughly covered in a one-hour presentation or a brief paper. Our objective is to provide a framework[1] that we hope will be useful to charitable gift planners in thinking about these types of gifts as they further investigate giving possibilities with the donor, the charity, and their respective advisors. Specifically, in this session we provide an *overview* of (1) business owner motivations and goals; (2) the major types of business ownership; and (3) the major planning issues that arise and the intersection of these goals, ownership structures, and charitable gift planning strategies.

II. Business Owner Motivations and Goals

Retire from Business. Many individuals look forward to living a graceful and prosperous retirement in their later years. When the founder of a family-owned business has set up a workable succession plan, the strategy takes the retirement plans of the founder into account. In

[1] See Appendix A for a single-page distillation of the issues associated with gifts of business interests involving C corporations, limited liability companies (LLCs), and S corporations. This is the framework for our presentation.

family-owned businesses or privately-held partnerships, it can be difficult deciding the best course of action when an owner is looking to retire or exit the business. The legal, financial, managerial, and emotional factors that come into play during this transition can be overwhelming. What can be more difficult is that many advisors (attorneys, financial advisors, and insurance providers) are each approaching the transition from their own perspectives.

Transfer or Sell Ownership to Family Members or Employees. From a family business owner's perspective, a major advantage of transferring the business to a family member or to key employees is that it provides an avenue for the family name to continue to be associated with the company, even after the owner has withdrawn from an active leadership role. However, it's not uncommon for the owner to remain involved in the business after the sale, working as an advisor, employee, or on-call problem solver. In fact, continuing involvement by the outgoing owner is often welcomed by the new owners, assuming the family or key employee relationship is healthy and intact.

Another advantage of family or key employee succession is that it gives more lead time to prepare the new owners for leadership responsibilities. Frequently, the new owners will intentionally seek employment outside the family-owned business for a time to broaden their experience and gain insight into facets of the industry that will benefit the company when they eventually take the helm.

Minimize Taxes. A well-crafted business succession plan uses strategies that minimize the tax consequences of any transfers of ownership or control of a family-owned company. Estate taxes alone can claim up to 45% of the value of the business, frequently resulting in a business having to liquidate or take on debt to keep the business afloat. To avoid a forced liquidation or the need to incur debt to pay estate taxes, there are a number of lifetime gifting strategies that can be implemented by the business owner to minimize (or possibly eliminate) estate taxes. Because of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, there is a two-year window for married couples to give away up to $10 million in gifts ($5 million for unmarried individuals). Taking advantage of this opportunity to make larger gifts tax-free, whether directly or through trusts, is another way to reduce a business owner's potential tax liability.

Make a Charitable Gift. Using a charitable gift as part of a business succession plan is a viable option for many business owners. This strategy can facilitate the transfer of a family-owned business with lower tax exposure, contribute to the business owner's retirement income, and create a permanent charitable legacy. Business owners often have a significant opportunity to achieve other financial, personal, or business goals through charitable giving strategies. Such strategies have the potential to reduce current tax liabilities, allow management of assets in tax-exempt entities such as charitable remainder trusts, and create additional income for the donor.

Realize Desired Value Given the First Four Motivations. At some point, every business owner exits his/her family-owned business and, in many cases, the business represents a significant portion of the family wealth. While most business owners recognize the importance of an exit strategy, fewer actually have a plan in place. The longer an owner has to implement a plan, the greater the opportunities to maximize the value of the family-owned business, minimize taxes, and achieve estate planning goals.

Succession planning should be viewed as a process rather than a one-time event. Though there are many key steps involved in developing an effective succession plan it is important to remember that charitable strategies can play an important role.

III. Types of Business Structures

After the 16th Amendment to the United States Constitution authorized a permanent income tax, entrepreneurs essentially had two choices when starting a business. They could form a corporation and obtain liability protection, but face two levels of federal income taxation (at the corporate and individual levels). Alternatively, they could choose to form a partnership or sole proprietorship, enjoy a single layer of income taxation (at the individual level), but sacrifice liability protection.

The landscape for business taxation remained relatively unchanged for the next four decades. Amid growing concern that the economy was increasingly becoming controlled by large multinational corporations, President Eisenhower recommended and Congress enacted, in 1958, legislation creating the small business corporation. The small business corporation concept allowed shareholder owners the "best of both worlds"—liability protection and a single level of taxation.

The Subchapter S Revision Act of 1982 (SSRA) introduced formally the terminology of S corporations (those corporations for which an election under §1362 of the Internal Revenue Code is in effect and whose taxation is governed by subchapter S of the Code) and C corporations (those corporations that do not have an S election in place). The SSRA was also intended to simplify the eligibility requirements and operations of S corporations. The number of S corporations in the United States began to increase dramatically in the 1980s and in the 1990s.[2]

In the late 1970s, another form of business organization arose that was also designed to achieve the twin goals of liability protection and a single level of income taxation. Limited liability companies (LLCs) are state law entities that are not technically corporations, but which have limited liability characteristics. The first LLC legislation was enacted in the late 1970s in

[2] See the website of The S Corporation Association (http://www.s-corp.org) and also www.taxhub.net.

Wyoming, followed a few years later by Florida. The Internal Revenue Service (IRS) first indicated that it would treat state law LLCs as partnerships for taxation purposes in 1988.[3] Today, LLCs can choose to be taxed as partnerships, C corporations, S corporations, or even as a sole proprietorship if the LLC has only one owner, or member. Most multiple member LLCs, however, are taxed as partnerships.

As can be seen in the table of IRS income tax return statistics below, S corporations were the most common form of limited liability business structure in this country as of 2007, the latest year for which statistics on all three types of entities are available. The most rapid growth between 1999 and 2007 occurred with LLCs, followed by S corporations. In contrast, the number of C corporations has declined over the past decade.

Table I
Selected Forms of Business Organization in the United States by Tax Return Filed

	1999	2002	2007
Limited Liability Companies (LLCs)	0.6 million	1.0 million	1.8 million
S Corporations	2.7 million	3.2 million	4.0 million
C and Other Corporations	2.1 million	2.3 million	1.9 million

Source: Tax Statistics of the Internal Revenue Service (www.irs.gov/taxstats)

Note that many S corporations filed for the S election in their first tax years. But many others also converted from C corporations to S corporations at some point after they were created, a fact that can have important planning implications.

[3] See Act of March 4, 1977, chapter 155, 1977 Wyoming Session Laws 512; Florida Statutes Annotated §§608.401-471; and Revenue Ruling 88-76, 1988-2 C.B. 360.

IV. Broad Charitable Giving Strategies Involving Business Succession

Outright Gift of Business Interest to Charity. If a corporation has sufficient cash reserves and/or cash flow from operations, it might be desirable for the principal shareholder to directly contribute stock in the corporation to charity, after which the corporation extends a redemption offer at its fair market value. In business succession planning situations, the owner will typically give to charity a sufficient number of shares so that, after the redemption by the corporation or ESOP, the remaining shareholders (often family members who have already acquired shares in the business) will hold the majority or controlling interest in the business. Alternatively, the charity might sell the shares to family members.

Whether or not the business owner has children or other family members involved in the business, he or she might desire to transfer control of the business to key employees. This could be accomplished by an outright gift of shares to the charity followed by a purchase of those shares by key employees or by an employee stock ownership plan (ESOP). The purchase might be accomplished all at once, or over time by means of an installment note.

These strategies are depicted in the following diagram.

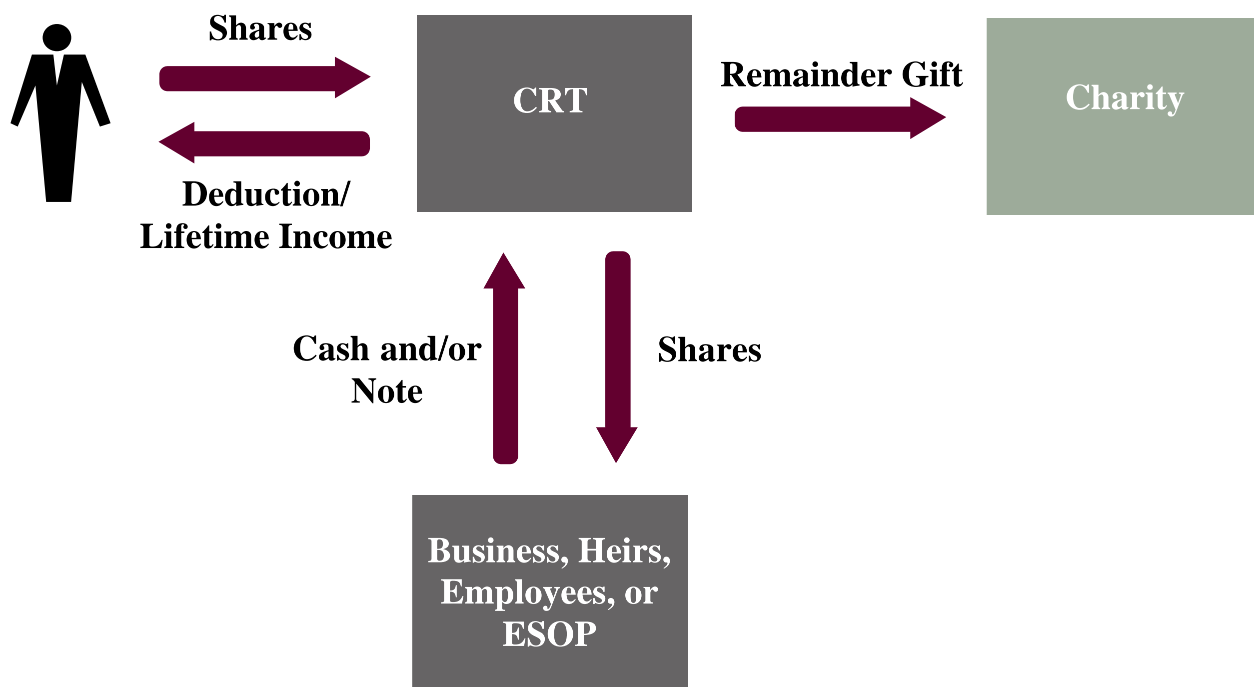
Outright Gift Followed by Redemption or Purchase

Note that this straightforward strategy is also employed when succession planning is not an issue. Perhaps no family members are involved in the business and no employees are interested in an ownership role. In that case, the owner is selling the business to a third party purchaser, but the same basic strategy can be employed to achieve the owner's financial planning and philanthropic objectives.

Gift of Business Interest to Charitable Remainder Trust. If a corporation has sufficient reserves and/or cash flow from operations, it might be desirable for a principal shareholder to transfer closely-held stock to a charitable remainder trust. The trust will pay the donor (or beneficiaries designated by the donor) a fixed dollar annuity or a variable unitrust amount every year for life. The donor will gain immediate tax savings because the present value of the charity's deferred interest will qualify for a charitable income tax deduction. Out-of-pocket capital gains taxes will be avoided no matter how much the stock has appreciated in value.

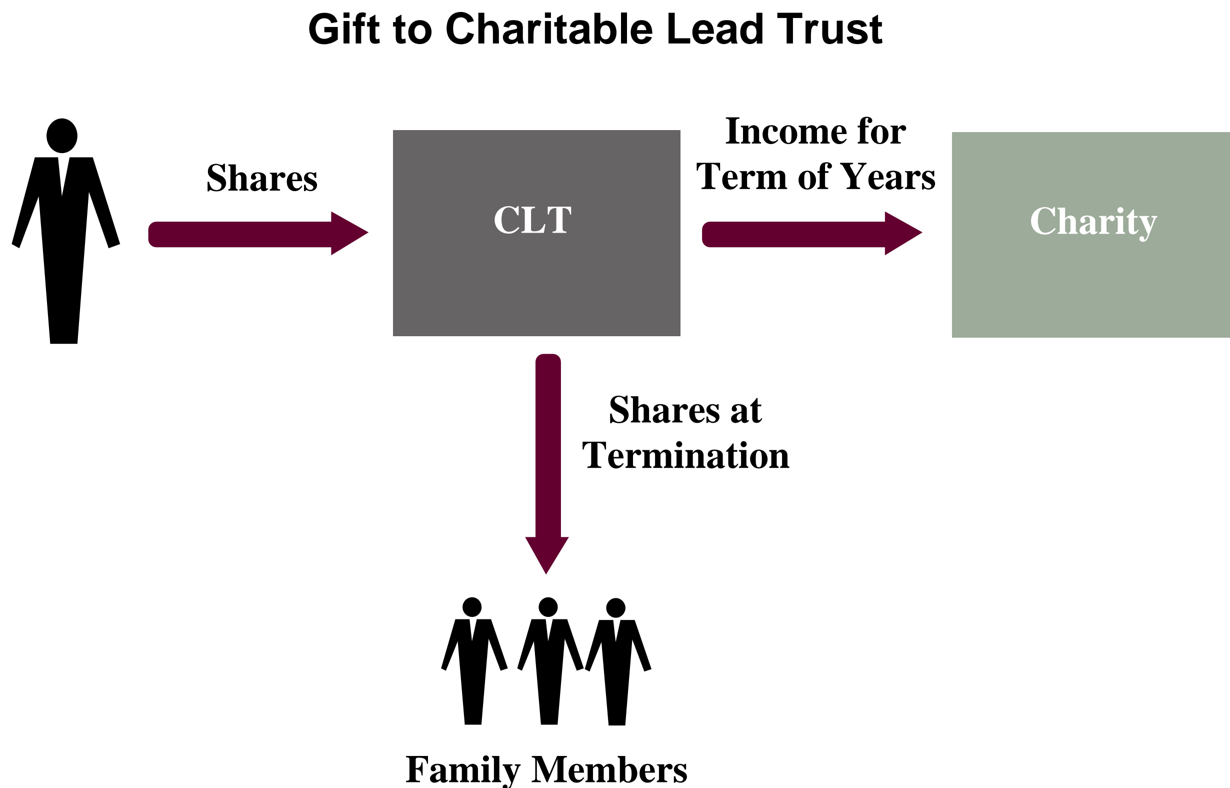
The source of liquidity for the charity can again be the corporation itself, heirs, key employees, an ESOP, or a third party purchaser. This strategy is depicted in the following diagram.

Gift to CRT Followed by Redemption or Purchase



Gift of Business Interest to Charitable Lead Trust. Charitable lead trusts (CLTs) are designed to provide income payments to at least one qualified charitable organization for a period measured by a fixed term of years, the lives of one or more individuals, or a combination of the two. After the trust ends, the assets are distributed to either the grantor or to one or more non-charitable beneficiaries named in the trust instrument, often family members.

In the case of closely-held stock or other business interests that generate regular cash flow, the lead trust offers an opportunity to retain ownership and control within the family, while minimizing transfer taxes. It is important to note that there are no purchasers in the context of this plan. The design is for the business assets to remain intact inside the CLT until trust termination.



As noted above, the aim of each strategy is that, after the transaction is complete, the heirs (or the employees) will hold a controlling interest in the business.

The balance of our presentation will examine the planning issues associated with gifts of business interests, analyzing them in the context of gifts of C corporation stock, LLC units, and S corporation stock—either outright or through charitable remainder and lead trusts.

V. Gift of Closely Held C Corporation Stock

In this section, we will first provide a basic definition of a C corporation, and then consider four planning issues that arise in conjunction with gifts of C corporation stock: (1) the terms of buy-sell agreements; (2) the "pre-arranged sale" problem; (3) business valuation, and (4) self-dealing rules that apply to gifts involving charitable remainder and lead trusts. Finally, we will briefly consider a recent example of an outright gift of C corporation stock in a business succession planning context.

Definition of C Corporation. A corporation is a separate entity for tax and nontax purposes that is established under state law, generally by filing articles of incorporation with an appropriate state agency and paying the necessary registration fees. Corporations often have written bylaws that govern their operations. Owners of corporations are usually referred to as shareholders and they usually receive stock certificates to evidence their ownership interests. Each shareholder's liability for debts of the corporation is limited to his, her or its investment in the corporation. This means that if the corporation is sued, shareholders are only liable to the extent of their investments in the corporation. Their personal assets are not on the line, as they would be if the business was a partnership or sole proprietorship. Any debts that the corporation might incur are also viewed as the corporation's responsibility. In other words, once the business is incorporated, shareholders are protected by the corporate veil, or limited liability. In addition to liability protection, organization of a business as a corporation provides for continuity of business existence and can make it easier to raise capital.

As noted earlier, a C corporation means a corporation that is taxed as a separate entity under the provisions of Subchapter C of the Internal Revenue Code. As a result, C corporations are subject to double taxation, which means that the profits are taxed once on the corporate level and a second time when they are distributed as dividends to the shareholders.

Buy-Sell Agreements. The transfer of stock in a privately held corporation (i.e., one that is not traded publicly on an established securities market) is often restricted by means of a buy-sell agreement. Buy-sell agreements allow the owners of a business to agree on the terms and conditions of a future disposition of an individual's interest in the business, whether that disposition is by sale, gift, or otherwise. They provide a framework for establishing the value of a business interest, and stipulate what individuals or other entities may own interests in the business. By creating a buy-sell agreement, the owners of a small, privately held business provide a roadmap for the processes that must inevitably occur when an owner gives or sells his business interest, dies, goes bankrupt, or gets divorced.

Typical buy-sell agreements specify the types of triggers that cause a mandatory or an optional buyout; a determination of the appropriate valuation date imposed by the agreement; the price and payment terms of the buy-sell obligation and the methods by which the agreement will be funded; non-compete agreements between the parties; and which transfers of an owner's interest are permitted and prohibited by the agreement. All types of closely-held businesses can and do use buy-sell agreements. Often, insurance is used to provide the liquidity needed to implement the buy-sell agreement upon the owner's death.

When a business owner is contemplating a charitable gift of his business interest, it is important to review whether the terms of the buy-sell agreement allow a charitable organization to own shares or units in the business. Other business owners might have rights—such as a right of first refusal—that need to be addressed before the gift can occur. Although issues surrounding buy-sell agreements often take time and effort to resolve, they are usually solvable, especially when the owner is the majority owner of the business.

Pre-Arranged Sales. It is a basic principle of federal income taxation that income is taxed to the taxpayer who earns it. The assignment of income doctrine prohibits the shifting of the income tax liability associated with recognition of gain away from a party whose right to the gain has matured. Business owners contemplating making an outright to charity or funding a charitable remainder trust most often encounter an assignment of income problem where the sale of the business is largely completed before title to their ownership interest is transferred to charity or the charitable remainder trust. The danger is that, if closely examined, the IRS might determine that the business owner recognized the capital gain inherent in the business interest prior to the transfer to charity (or a CRT). This could result in significant personal income tax liability when the proceeds from the sale of the business interest are no longer available to the business owner because they now belong to the charity or the CRT.

Below we review four cases that shed further light on this question of pre-arranged sales.

Palmer v. Commissioner.[4] In this decision, the United States Tax Court ruled that a contribution of stock in a for-profit corporation (the Palmer College of Chiropractic in Davenport, Iowa) to a private foundation, followed by the corporation's independent offer to redeem the stock and the foundation's acceptance of the redemption offer, did not violate the assignment of income doctrine. This was found to be true, even though the donors had voting control of both the corporation and the recipient private foundation. The Court reasoned as follows:

> …[T]here were two paths which he could have taken—he could have had the stock redeemed and then made a contribution of the assets, or he could have contributed the

[4] *Palmer v. Commissioner*, 62 T.C. 684 (T.C. 1974)

> stock and let the donee arrange for the redemption. The tax consequences to the donor turn on which path he chooses, and so long as there is substance to what he does, there is no requirement that he choose the more expensive way….Even though the donor anticipated or was aware that the redemption was imminent, *the presence of an actual gift and the absence of an obligation to have the stock redeemed* have been sufficient to give such gifts independent significance.[5] [Emphasis added.]

After its loss in the *Palmer* and other similar cases, the IRS issued a revenue ruling acquiescing on this issue and stating:

> The Service will treat the proceeds of redemption of stock under facts similar to those in *Palmer* as income to the donor only if the donee is legally bound, or can be compelled by the corporation, to surrender the shares for redemption.[6]

The Palmer case and the 1978 Revenue Ruling appeared to establish something of a "bright line" when it came to the issue of assignment of income: if the charity recipient is not legally bound and cannot be compelled to surrender the shares for redemption, there is no assignment of income.

***Blake v. Commissioner*.**[7] In a decision reached late in 1982, the United States Court of Appeals for the Second Circuit ruled that the capital gain on the sale of stock contributed to charity was indeed taxable to the donor (Mr. Blake).

Mr. Blake owned a yacht, the *America*, a replica of the original 1851 yacht after which the America's Cup race was named. As with many yacht owners, he eventually wished to dispose of his boat. However, potential donees would not take the boat without his providing additional financial support for its maintenance. There also seemed to be some question as to the value of the yacht, for which he had paid $500,000. Mr. Blake therefore donated a substantial number of shares of the Friendly Ice Cream Company, which he co-founded, to the charity. The charity then sold the stock for $714,000, and purchased the yacht from Mr. Blake for $675,000.

Although there was no written agreement between the donor and the charity (the Kings Point Fund), the court held:

> We need not decide which of the three states' law would govern, however, because we are certain that each state would consider the Fund legally obligated to purchase the *America* under a theory of promissory estoppel on the facts of this case. Under

[5] *Ibid*, at 693
[6] Revenue Ruling 78-197
[7] *Blake v. Commissioner*, 697 F.2d 473 (2d Cir. 1982)

> this theory, a mere gratuitous promise by the Fund that it would purchase the *America* became legally binding when acted in reliance on such an assurance.

Mr. Blake's case was not helped by his testimony that "…that he would not have made a donation as substantial as the amount of the market value of the stock he transferred 'except for the boat thing.'"[8]

The court's holding on this particular issue has, so far, been limited to the facts in *Blake* (a donation of assets with an expectation that the value would be used to purchase an asset of the donor). The appellate court went on to state:

> We hold that where there is an understanding that a contribution of appreciated property will be utilized by the donee charity for the purpose of purchasing an asset of the contributor, the transaction will be viewed as a matter of tax law as a contribution of the asset—at whatever its then value is—with the charity acting as a conduit of the proceeds from the sale of the stock. This makes the taxpayer/putative donor taxable on the gain of the stock though entitled to deduct the value of the asset given, whatever that value in fact is.[9]

In *Blake*, the Second Circuit also questioned the Service's acquiescing in *Palmer*, but the Service declined the invitation to revisit their position. The Service continued to issue rulings citing *Palmer* and Revenue Ruling 78-197 to taxpayers who wanted the assurance that they would not be taxed on income or gains from donated property.

Ferguson v. Commissioner.[10] In a decision reached in the spring of 1999, the United States Court of Appeals for the Ninth Circuit affirmed a Tax Court opinion that "the stock already had ripened from an interest in a viable corporation into a fixed right to receive cash via an ongoing tender offer" and that therefore the Fergusons were taxable on the gain in the donated stock under the assignment of income doctrine."[11]

The Ferguson family owned and managed Diet Center ("DC"), a subsidiary of American Health Companies ("AHC"). AHC entered into a merger agreement with CDI Holding Inc., a company established to facilitate the purchase of AHC by third parties. AHC's board unanimously approved the merger agreement. The merger was contingent on 85% of the shares being tendered, but that condition could be waived unilaterally by the buyer.

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[8] *Ibid*, at 478
[9] *Ibid*., at 480
[10] *Ferguson v. Commissioner*, 174 F.3d 997 (9th Cir. 1999)
[11] *Ibid*., at 998

In mid-August, the Fergusons transferred restricted stock (evidenced by a legend on the certificates) in their company (AHC) into a brokerage account. The brokerage's legal department believed the stock could not be given until the legend was cleared. (As it turned out, the legend should not have impaired the donation. It restricted only the sale of the shares, and not other types of transfers.) That clearance was not effective until the 9th of September, at which time several charitable gifts were made by the Ferguson family.

Unfortunately for the Fergusons, events did not stand still while they were waiting for legal clearances. By close of business on August 31, more than 50% of the outstanding shares had been tendered to the acquirer. The charities subsequently sold the shares to CDI Holding pursuant to the tender offer.

As noted earlier, the court concluded that the stock had "ripened"—for anticipatory assignment of income purposes—into a fixed right to receive cash prior to the date of the contributions and therefore the donors were taxable on the gain on the stock. Although the percentage of stock tendered did not reach 85% until the close of business on September 9, that condition could have been waived by the acquirer without the consent of the sellers. The court held that once 50% of the shares had been tendered, the merger was substantially certain to occur, and any transfers after that date were transfers of the right to receive cash, not the shares themselves. The only possible contingency preventing the merger would have been a withdrawal of tendered shares, which the court considered to be remote.

It is worth noting that the IRS contended that the July 28 merger agreement, coupled with the August 3 tender offer was, in reality and substance, the functional equivalent to a shareholder vote approving the merger agreement. It did not matter in this particular case, but the court, by adopting the August 31 date as the cut-off date, seems to have rejected this assertion. Given the number of recent business mergers that have been announced but not consummated (or consummated at a different price after a second bidder appeared), this seems to be in accordance with economic and legal realities. Of course, the Fergusons were still entitled to their charitable deduction, but it was considered to be a gift of cash, not stock.

Although *Ferguson* initially caused waves of concern in the charitable giving community, a close examination of the facts left many donors and their advisors feeling comfortable that the *Palmer* doctrine still applied. As long as the donee could not be legally compelled to surrender the donated property, the donation was still effective.

Rauenhorst v. Commissioner.[12] In this case, the IRS argued that a gift of warrants for the purchase of stock was too late in the sale process to avoid recognition of capital gain by the donor. The Tax Court disagreed and granted the donor partial summary judgment on the issue.

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[12] *Rauenhorst v. Commissioner*, 119 T.C. 157 (T.C. 2002)

The donors owned warrants that allowed them to acquire 772.14 shares of stock in a company named NMG. On September 28, 1993, a company named World Color Press, Inc. (WCP) offered to purchase NMG. On that date, the NMG directors signed a letter of intent describing general terms for the prospective purchase of NMG by WCP. However, the letter of intent was not a legally binding sale contract.

On November 8, 1993, donors transferred warrants for the right to purchase 770 shares of NMG to four charities. On November 12, 1993, NMG reflected the transfer on its warrant ledger. On November 19, 1993, the donors and the four charities agreed to sell all shares to WCP. The IRS claimed that the transfer by the donors had been too late and issued a deficiency on November 18, 1999 for the tax year 1993. The Service claimed that the donors owed tax on capital gains totaling $4,722,484. After carefully reviewing the facts and Rev. Rul. 78-197, the Tax Court concluded that the donors had acted properly to avoid recognition of the capital gain.

As the Tax Court noted, "The letter of intent was not an offer; it was neither a purchase, tender, or exchange offer…." Neither did the resolution of WCP's board of directors accepting the letter of intent "demonstrate that the warrant holders were legally bound, or could be compelled, to sell their stock warrants at the time of the assignments."[13]

Revenue Ruling 78-197 explicitly states that the gain will be recognized "only if the donee is legally bound, or can be compelled by the corporation, to surrender the shares for redemption." Since the corporate ledger of NMG regarding share ownership was changed on November 12 and the sale occurred one week later on November 19, there was ample evidence of the prior transfer. Furthermore, on November 12, there was no evidence of a legally binding obligation requiring the charities to sell to WCP. Thus, the donors were permitted to avoid recognition of capital gain on the charitable gifts.

Near the end of the *Rauenhorst* opinion, the Tax Court noted the IRS had continuing commitment to serve the public by providing guidance on tax matters in the form of published Revenue Rulings. This goal would not be achieved if the IRS failed to follow its own guidance, or argued in court proceedings that revenue rulings do not bind the IRS, or maintained that its rulings were incorrect. In language that resembled chiding, the Court noted:

> Certainly, the Commissioner's failure to follow his own rulings would be unfair to those taxpayers, such as petitioners herein, who have relied on revenue rulings to structure their transactions. Moreover, it is highly inequitable to impose penalties, which respondent has done in this case. Accordingly, in this case, we shall not permit

[13] *Ibid*., at 179

> respondent to argue against his revenue ruling, and we shall treat his revenue ruling [i.e., Revenue Ruling 78-197] as a concession.[14]

***Summary*.** Two of the above four cases (*Palmer* and *Rauenhorst*) were resolved favorably to the donors/taxpayers, and two (*Blake* and *Ferguson*) were not. Depending on individual fact patterns, donors and their counsel might feel they can rely on Revenue Ruling 78-197 as a "bright line" to protect the successful completion of their gifts. However, where negotiations have already commenced prior to a transfer of a business interest to a charity or a charitable remainder trust, prudence dictates that, if possible, negotiations be halted, the transfer to the charity or the charitable remainder trust be completed, and then, new negotiations begun.

Business Valuation. One of the key concerns with a charitable gift of a business interest is correctly determining the value of the gift. The purchasers of the contributed business interest (whether they are employees, heirs, other owners, an ESOP, or a third party) are concerned that they pay an appropriate price. The charity wants to realize a good value for its gift and avoid any problems, under the concepts of private inurement or IRS "intermediate sanctions," for accepting too low a price[15]. Under the common law duty of loyalty to beneficiaries, trustees of charitable remainder trusts must obtain an appropriate value on the sale of trust assets. Finally, the donor is usually interested in an appropriate value for purposes of the federal income tax charitable deduction. Of course, these various parties have interests that are adverse to one another. Indeed, the donor himself or herself might prefer higher valuations for one purpose (the federal income tax charitable deduction) and lower valuations for other purposes (federal gift taxes associated with other gifts of the business interests to family members).

Buy-sell agreements often contain provisions dealing with business valuation, but an appraisal of the business will almost always be required to establish the value of the business interest. The cost of appraising closely-held business interests can be quite high. Such an appraisal requires that the entire business first be valued, and then an adjustment made for the fact that the contributed interest is usually a minority interest (less than 50% of the company). Further adjustments are normally made to reflect the lack of marketability of the business interest.

If the donor wishes to claim a federal income tax deduction in excess of $10,000, a qualified appraisal by a qualified appraiser will also be needed.[16] Finding a qualified appraiser can sometimes be difficult, but often a privately-held business will obtain appraisals for other purposes such as ESOP administration, insurance, or in connection with commercial financing or financial statement activities. Although these appraisals almost invariably fail to meet all of the qualified appraisal requirements, they constitute good starting points and might represent opportunities to secure a qualified appraisal at a more economical cost.

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[14] *Ibid*, at 183
[15] See Treas. Reg. §1.501(c)(3)-1.
[16] See IRC §170(f)(11), IRS Notice 2006-96, and Treas. Reg. §1.170A-13(c).

Self-Dealing Rules. Charitable remainder and lead trusts, in addition to private foundations, are subject to what are known as "self-dealing rules" that, when violated, result in onerous excise taxes.[17] The self-dealing problem is triggered when a "disqualified person" is involved with the charitable remainder or lead trust in a sale, lease, loan, or other transaction.[18] A disqualified person can be the donor; lineal ascendants and descendants and their spouses; and also trusts, corporations, or partnerships in which the donor and/or family members have more than a 35% interest.[19] A qualified public charity is not a disqualified person, and the self-dealing rules do not apply to outright gifts, bargain sales, or charitable gift annuities.

The self-dealing rules are of concern when family members are interested in reacquiring business interests transferred to a charitable remainder or lead trust. They are not avoided by using intermediaries, whether individuals or organizations. For example, if a parent transfers a warehouse into a charitable remainder unitrust and is interested in selling that warehouse to his or her children, the sale is self-dealing whether done directly or through an intermediary. The children may not create a corporation, LLC, or other business entity and use that to purchase the warehouse. That would also be a violation of the indirect self-dealing provisions.[20]

An important exemption from the self-dealing rules exists for corporations and LLCs that are disqualified persons because the donor and his or her family members control more than 35% of the business. Without this exception, these businesses could not redeem the contributed stock from the charitable remainder or lead trust without incurring excise taxes. To meet the requirements of the exception, the offer to redeem the stock from the charitable remainder or lead trust must be at fair market value and must be subject to the same terms as any offer extended to other shareholders of the same class.[21] Said differently, the trust or foundation must be afforded at least as favorable treatment as other holders of securities in the corporation in order for the transaction not to be considered self-dealing. Compensating the trust or foundation with property, such as debentures, for its stock when other holders of identical stock receive cash would not be considered treating the trust or foundation on a uniform basis.

Note that the offer need not be extended to all shareholders of the same class. In one case, for securities law and conflict of interest reasons, a corporation excluded officers and directors from a redemption offer that was extended to a private foundation that had received a testamentary gift of the company's shares. An appeals court concluded the redemption met the self-dealing exception because the lower court's interpretation of Treasury regulations exceeded the statute

[17] IRC §4947(a)(2)
[18] IRC §4941(d)(1)
[19] IRC §4946(d)
[20] Treas. Reg. 53.4941(d)(1)(a)
[21] IRC §4941(d)(2)(F)

and failed to take into account “the pragmatic fact that officers and directors are variously restrained and regulated in transactions in the stock of the company they serve.”[22]

Unrelated Business Income Tax. A more extensive discussion of unrelated business income tax (UBTI) as it relates to gifts of business interests appears in the discussion in Section VI relating to gifts of LLC or partnership interests. In limited cases, UBTI can be a consideration with gifts of C corporation stock.

In general, interest, rents, royalties and annuities (“specified payments”) are excluded from the UBTI of tax-exempt organizations. However, the tax law treats otherwise excluded specified payments as UBTI if the income is received from a taxable or tax-exempt subsidiary that is 50% controlled by the parent tax-exempt organization, to the extent that the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity.[23] In the context of business succession planning, it would be unusual for a donor to transfer more than 50% of the stock in a corporation to charity. But if a charity (or charitable remainder or lead trust) does own more than a 50% interest in the C corporation after the gift, there might be UBTI liabilities to be paid.

Actual Case Study: Outright Gift of Closely-Held C Corporation Stock

Bill and Bonnie Nittany[24], both in their 60s, own and operate a very successful business that is structured as a C corporation and valued in excess of $100 million. The Nittanys are getting ready to retire and want to give something back to their community. Over the years, using gift tax exclusions and their available gift tax exemption, they have given a significant number of shares of the corporation stock to their children and other family members. In addition, they have established an ESOP which owns about 10% of the corporation. According to the shareholder agreement, the only people who can own the stock are family members, employees, or nonprofit entities. The Nittanys are very charitable and intend to transfer shares in their company to Penn State.

Because Penn State is a governmental entity, it arranges for the gift to be made to a subsidiary entity that is a qualified charity. The Nittanys transfer 1,000 shares to that entity before the annual shareholder meeting. The family holds a shareholder meeting once a year where the stock valuation is disclosed. The fair market value of the shares given to charity on the subsequent annual valuation date was $1,500 per share. There is no binding agreement that the corporation will repurchase these shares from the charity, but when the charity offers to sell its

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[22] See Deluxe Corp. v. United States, 885 F.2d 848 (Fed. Cir. 1989) and also Treas. Reg. §53.4951(d)-3(d)(1).
[23] IRC §512(b)(13)
[24] Although the donor names and a few minor facts have been changed, this case and the others in this paper represent actual gifts received in the recent past by KASPICK & COMPANY clients.

shares to the corporation six weeks after the gift, the corporation agrees to the repurchase and pays charity $1,500,000 for the stock.

Following the repurchase, the charity has $1,500,000 cash and the corporation holds the shares as treasury stock. The Nittanys have received a personal income tax deduction of $1,500,000 (minus appropriate discounts for lack of marketability and minority interest) for their gift based on a qualified appraisal completed after the gift was made.

Through this transaction, the Nittanys have reduced the number of shares that will eventually need to be transferred to their family. This saves income, gift, and future estate taxes.

VI. Gift of Limited Liability Company (LLC) Units

Background. As noted above, owners of both Limited Liability Companies (LLCs) and S corporations generally enjoy a single level of income taxation, but the growth rate of LLCs has exceeded that of S corporations over the past decade or so. This might be due to the fact the LLCs have fewer restrictions on the number of allowable shareholders, the types of share or ownership classes that may be employed, or the number of allowable subsidiaries. Depending on the state in which the LLC is organized, it might also be easier to set up and maintain an LLC than it is an S corporation.

Charitable Gifts of LLC Units. Because most multiple-member LLCs are taxed as partnerships, we will confine the discussion of the charitable gift planning issues associated with gifts of LLC units to those LLCs taxed as partnerships. Perhaps the primary gift planning issue associated with gifts of LLC units is that, because of the pass-through nature of the business organization, operating businesses will generate what is called unrelated business taxable income (UBTI) to the charity, CRT, or CLT that is the recipient of the gift. The tax consequences of UBTI to the charity, CRT, or CLT can be a significant deterrent to these gifts.

Prior to the Revenue Act of 1950, charities in the United States could generally own and profit from a wide variety of businesses that might or might not be related to the purposes for which the charities were organized. The general prevailing principle was that mattered most was not the *source* of the income a charity might receive, but that the *destination* of income was a charitable purpose that society ought to support.[25] Two problems existed with the destination of income approach. One is that the United States Treasury was losing a significant source of tax revenue when charities owned and operated unrelated businesses[26]. The other is that allowing charities to

[25] This doctrine was laid down in a United States Supreme Court decision in the 1920s. See *Trinidad v. Sagrada Orden de Predicadores,* 263 US 578, T.D. 3548, III–1 C.B. 270 (1924).
[26] Adolph J. Sabath, a Congressman from Illinois who served from 1907 until his death in 1952, exclaimed that "the involvement of educational institutions in the field of banking, real estate, commerce, and industry goes merrily on.

operate unrelated businesses gives them competitive advantage relative to for-profit businesses which must pay tax on the income they earn. The UBTI system first enacted in 1950, and later expanded and improved in the Tax Reform Act of 1969, was an attempt to redress this problem of unfair competition.

Income earned by a tax-exempt organization will be considered UBTI if it meets all of the following tests:

- The income is from a trade or business;
- The trade or business is regularly carried on; and
- The conduct of the trade or business is substantially unrelated to the performance by the charity of its exempt functions.[27]

One can readily see that all of these tests will be met in many instances where a member of an LLC contributes units to charity. For example, if the owner of a business that develops software for robotics contributes units in her LLC to an environmental charity, it is clear that the income is from a trade or business regularly carried on that is unrelated to the mission of the environmental charity. The UBTI derived by the charity during its period of ownership of the units would be subject to taxation at C corporation rates (if the charity is organized as a corporation) or at trust rates (if the charity is organized as a charitable trust). A charity might still accept an outright gift of LLC units, even though it produces UBTI.[28] However, careful attention must be paid to how much UBTI will be realized, what tax might be owed on that UBTI, and whether the gift will be counted or recognized at its gross amount, or net of any associated tax liabilities. Charities with losses from other unrelated activities might be less concerned if they can net those losses against the UBTI from the gift.

If a charitable remainder or lead trust is the recipient of a gift of LLC units, only the first two tests need be met to trigger UBTI, because by definition CRTs and CLTs do not themselves have tax-exempt charitable purposes. Since 2007, the UBTI incurred by a CRT is subject to a confiscatory tax rate of 100%.[29] If a CLT realizes UBTI, it loses the normal IRC §642(c) deduction allowed to taxable trusts for distributions to charity. Instead, payments made to

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Universities own haberdasheries, citrus groves, movies, cattle ranches, the Encyclopedia Britannica (owned by the University of Chicago), and a large variety of other enterprises…. Universities and colleges, together with foundations, have an annual income from their business activities of well over a half billion dollars annually. Were this income not tax-exempt, they would pay $173,000,000 in Federal Taxes annually." See the Congressional Record, Vol. 96, Part 7, pp. 9273–9274, quoted in the legislative history of the UBTI on the IRS website.

[27] Treas. Reg. §1.513-1(a)

[28] Some charities might have unrelated business income losses, for example, that could offset UBTI generated by the gift.

[29] IRC §664(c)(2)(A). Prior to 2007, a CRT lost its income tax exemption when it had UBTI. Generally speaking, the new treatment can be helpful with gifts of real estate to CRTs that have small amounts of associated UBTI (e.g., from vending machines). In cases where UBTI is a result of debt on the real estate, the consequences of UBTI can still be severe.

charity that are allocable to the UBTI are deductible under the normal adjusted gross income limitations for charitable contributions made by individuals.[30]

Because of the generally onerous impact of UBTI upon outright or split-interest charitable gifts, most successful gifts of LLC business interests are likely to involve businesses that generate income that qualifies for exceptions to UBTI. When Congress enacted and refined the UBTI taxation regime, it excluded a number of types of passive income from the definition of UBTI on the rationale that these types of passive income are not generally derived from activities that compete directly with for-profit entities. The types of income generally excluded from the definition of UBTI include:

- Dividends, interest, and annuities
- Royalties
- Rents from real property that are not based on a percentage of profits
- Incidental rents from personal property leased in conjunction with real property
- Gains from capital investments

In the authors' collective experience, the nature of these exceptions from UBTI narrow down the possible types of LLC interests that can be given to CRTs or CLTs to limited liability companies that hold commercial or residential real rental property. The income received by the CRT or CLT from these types of LLCs often qualify for the real property rents exception noted above *provided* the income from the real property does not constitute what is known as debt-financed income.

A detailed discussion of the policy goals and technical applications of debt-financed income is beyond the scope of this paper. What is important to understand is that any gift property with respect to which there is "acquisition indebtedness" will generally produce "debt-financed income" that is UBTI in the hands of a charity, a CRT, or a CLT.[31] Acquisition indebtedness includes any debt that is incurred to acquire or improve the property before, during, or after its acquisition by the LLC. A limited exception (sometimes referred to informally as the "old and cold exception") applies to property acquired more than five years before the gift, and where the acquisition indebtedness was incurred more than five years prior to the gift. In that instance, the income from such a property will not be considered debt-financed income for a period of 10 years from the date of the gift.[32] To qualify for this exception, the charity, CRT, or CLT must not agree to pay or assume the indebtedness on the gift property.

[30] IRC §681(a)
[31] See IRC §514 and the Regulations thereunder.
[32] See IRC §514(c)(2)(b).

If the charity, a CRT, or a CLT owns a property with acquisition indebtedness, the amount of UBTI generated by this investment is generally determined by applying what is known as a "debt-basis fraction" to all items of income and deduction generated by the property (including gain or loss from the sale of the property).[33] For example, if the average acquisition indebtedness outstanding on the property during the tax year was $250,000 and the average amount of the adjusted basis of the property during the tax year was $500,000, then the debt-basis fraction applied to all items of income and expense would be 50%. If the capital gain on the sale of the property were $4 million, 50% of the $4 million, or $2 million, would be debt-financed income taxable income to the CRT (at a 100% rate) or CLT (at normal trust rates after all deductions are applied).

Successful gifts of LLC interests to CRTs and CLTs therefore tend to involve interests in LLCs that own unencumbered rental property. If the property owned by an LLC is encumbered and the donor wishes to proceed with a life income gift, the first strategy is generally to determine whether the debt can be removed from the property prior to the gift. If the debt on the property is "old and cold," it might be possible to structure a successful gift that will not incur UBTI. Obviously, careful review by the qualified tax counsel employed by the donor is critically important.

Although our analysis of gifts of LLC interests has focused on the UBTI problem, it is critical to note that the issues of buy-sell agreement provisions, pre-arranged sales, and self-dealing rules (if the gift of LLC units is to a CRT or CLT) still apply. Also, when LLCs are taxed as partnerships, a number of other considerations beyond the scope of this paper come into play. For example, the donor's charitable deduction must reduced to reflect the amount of ordinary income (instead of long-term capital gain) that would have been realized if a proportionate amount of each of the partnership assets had been sold instead of given to charity. And if the partner is relieved of any partnership debt as a result of the gift, this will give rise to bargain sale recognition of gain.

Actual Case Study: Gift of LLC Units to Charitable Remainder Lead Trust

Steve and Margaret Lyons are in their late 70s. They own two valuable commercial rental properties held in a LLC, that are together worth several millions dollars. They wish to pass these properties to their children. Steve is long-time contributor to State University and is a member of the University's Campaign Leadership Council. The Dean of the School of Engineering would like Steve and Margaret to endow a chair as part of the campaign.

[33] See IRC §514(a)(1).

As the charitable federal mid-term rate (CFMR) approached 2.0% near the end of 2010, the estate planning attorney working with Steve and Margaret proposes the establishment of a charitable lead annuity trust (CLAT) funded with interests in the LLC as an excellent strategy for transferring the two rental properties to their three children at a low estate tax cost. Neither of the properties has any debt. The properties are sited in excellent locations and are subject to longer-term, fixed-rent ground leases to financially sound lessees.

The absence of debt and the fixed-rent lease payments mean that the properties will not generate UBTI to the charitable lead trust. Although the charity's lead interest in the trust is greater than 60% of the trust's value, the lead trust will not have difficulties with the excise tax provisions related to excess business holdings because of an exception for business enterprises that derive more than 95% of their income from passive sources.[34]

Steve and Margaret have concerns about what would happen if unforeseen circumstances should arise and the net lease income from the properties was insufficient to make the lead trust payments to the engineering school. They also realize that it is likely the roof on one of the properties will need to be replaced during the lead trust term. Because borrowing money to make these repairs would introduce UBTI problems, Steve and Margaret determined that they would make a contribution of liquid assets on the same day the CLAT was funded with the LLC units. This provided a "liquidity cushion" for contingencies.

Finally, Steve and Margaret asked that State University serve as trustee of the lead trust. After an extensive due diligence process, State University agreed to do so. However, all of the parties to the gift arrangement agreed to a Letter of Understanding that set forth foreseeable problems and how they might be addressed. For example, if liquidity problems arose, the CLAT might need to borrow funds from State University or transfer LLC units to State University in lieu of a lead trust payment, even though these actions might give rise to unfavorable income tax consequences. The Letter of Understanding made clear that the donor's intent to benefit State University must take precedence over the desired tax outcomes associated with the plan.

VII. Gift of S Corporation Stock

Background. Because the intent of S corporation status was to benefit small business formation in the United States, a number of requirements must be met if the corporation is to successfully

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[34] See IRC §4943(d)(3)(B). The excise tax on excess business holdings was designed to keep private foundations focused on their charitable purposes and not on running businesses. The rules are applicable to CLTs when the charity's income interest exceeds 60% of the trust's value. Generally speaking, the tax applies to holdings in a business by a private foundation and all of its disqualified persons that exceed certain a threshold permitted amount of 20% of the voting stock.

elect to be taxed under the beneficial rules of Subchapter S (an S corporation) of the Internal Revenue Code, as opposed to subchapter C (a C corporation) [35]:

- The corporation must be domestic corporation
- The corporation can have only one class of stock
- The corporation must have not more than 100 shareholders
- The corporation shareholders must be United States citizens or residents and generally be natural born persons

There are limited exceptions to the last restriction enumerated above that allow certain trusts (but not charitable remainder trusts) as well as tax-exempt corporations (charities) to be shareholders. The ability of charitable organizations to be S corporation shareholders was first achieved in 1998, and this at least opened the door to the possibility of charitable gifts of shares of S corporation stock.

Planning Issues. If a shareholder in an S corporation is interested in making a charitable gift of his/her shares, the gift planner must still be concerned with the many of the questions discussed earlier in regard to gifts of C corporation shares or LLC units. For example:

- Do the bylaws of the corporation allow charities to be shareholders?
- Are there restrictions on the transfer of the shares such that the approval of other shareholders (if any) is needed?
- Has the shareholder already recognized the capital gain inherent in the shares by committing legally to the sale of the shares?

Because charitable remainder trusts cannot be shareholders of an S corporation without voiding the S election, as a practical matter it is usually unnecessary to be concerned with the application of the self-dealing rules with gifts of S corporation stock.

The unrelated business taxable income (UBTI) issue is of even more concern with gifts of S corporation stock than it is with gifts of LLC units. This is because the IRC specifically states that if a charity owns stock in an S corporation, "such interest shall be treated as an interest in an unrelated trade or business" and "all items of income, loss, or deduction taken into account under section 1366(a)"—the section of the IRC that requires S corporation shareholders to include a pro rata share of the S corporation's income on their personal returns—"shall be taken into account in computing the unrelated business taxable income" of the charity.[36]

[35] IRC §1361
[36] IRC §512(e)(1)

Note that it does not matter what type of income the S corporation earns. It might earn interest, dividends, or rents that would otherwise qualify for exclusion from UBTI. But if these items of income are attributable to a charity's interest in S corporation income, they will be UBTI in the hands of the charity and therefore subject to tax at rates as high as 35%.

In addition to this application of UBTI treatment to all income earned by the S corporation, a charity will be taxable under the UBTI rules on the gain it recognizes when it sells the contributed S stock back to the corporation or to a third party.[37]

Because of these UBTI disadvantages, a charity must be rigorous in its evaluation of potential gifts of S corporation stock. In addition to evaluating what the stock is worth and how the charity will liquidate its interest, it must be concerned with the amount and timing of cash distributions from the corporation prior to liquidation of the shares, and how that cash flow compares with the amount and timing of UBTI tax liabilities that must be paid. The charity also needs know the donor's basis in the S corporation stock since that will affect the amount of gain (or loss) on the sale of stock.[38]

Gifts of S corporation stock are also disadvantageous from the donor's point of view. The Internal Revenue Code treats the contribution of S corporation stock similarly to the gift of a partnership interest. This means that the shareholder must reduce his/her charitable deduction by the amount of ordinary income that would have been recognized if all of the S corporation's assets had been liquidated on the date of the gift.[39] (These assets are informally known as "hot assets.") Although the proportion of ordinary income assets such as inventory (as opposed to capital assets) owned by the S corporation might be small, this rule nevertheless usually results in a charitable deduction for the donor that is less than the appraised value of the donated stock.

Charitable Gifts of S Corporation Assets. It is often better for the S corporation itself to make a charitable gift of one of its assets than it is for the shareholder to make a gift of the S corporation stock. Below are some of advantages of this approach:

- If the S corporation gives cash or marketable securities to the charity, there is no need for the qualified appraisal that would be required for a gift of the stock
- A charitable deduction for the gift of an S corporation asset need not be discounted for lack of marketability, as would a gift of stock
- The "partnership hot asset rules" do not apply to a gift by an S corporation of one of its assets

[37] IRC§512(e)(1)(B)(ii)

[38] For an excellent review of these issues, see the article entitled "Gifts from Subchapter S Corporations and Their Shareholders" by Christopher R. Hoyt, published in the proceedings of the 2006 National Conference on Planned Giving.

[39] IRC§170(e)(1) and §751

- The charity will not have to pay UBTI as a result of the gift (unless the gift asset produces debt-financed income, as in the case of a gift of mortgaged real estate)
- A gift of S corporation assets can be made to a term-of-years charitable remainder trust (CRT), whereas a gift of S corporation stock cannot be made to a CRT without voiding the S election

Because of the flow-through nature of the taxation of S corporations, shareholders will be able to claim a charitable deduction for their pro rata share of the charitable contribution (subject to all of the normal rules regarding deductibility ceilings, etc.)[40] Of course, if the corporation has many shareholders, it is likely that not all of them will want to make a charitable gift to a particular charity. It is worth noting, however, that for the tax year 2007 approximately 89% of all S corporations had two or fewer shareholders.[41] Even in cases where there are multiple shareholders, it might be possible for the S corporation to make its gift to a donor advised fund (DAF), with each of the S corporation shareholders having the authority to advise proportional gifts from the DAF to his/her charity of choice.[42]

In addition to the complication of multiple shareholders, there are some potential disadvantages to direct gifts to charity by an S corporation. The shareholders might have a low basis in their shares such that the pro rata charitable contribution is not fully deductible. For example, if the shareholder's allocable charitable deduction for the gift is $25,000 and the basis in his/her shares is only $10,000; he/she will only be able to claim a $10,000 income tax charitable deduction.

If the S corporation contributes "substantially all" of its assets to charity, the transaction will be treated as if the corporation had liquidated. This in turn means the S corporation will be treated as if it had sold the assets that were given to the charity and instead distributed the cash proceeds. Assuming the assets were appreciated above cost basis, this would result in recognition of gain.[43] The language "substantially all" is not specifically defined in the tax law[44].

There is also a potential issue associated with the "BIG" tax, or "built-in gains tax" of IRC §1374, at least with respect to gift to charitable remainder trusts. The BIG tax applies only to S corporations that were once C corporations. When a C corporation converts to an S corporation,

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[40] Under special "extender" provisions of the tax law in effect since 2006, the shareholders' bases in their S corporation shares will be reduced only by their pro rata shares in the S corporation's basis in the contributed property, rather than the market value of the contributed property, as had been the case before the Pension Protection Act of 2006. This places S corporation shareholders on an equal footing with partners in a partnership that makes charitable gifts of appreciated property.
[41] See Figure G, S Corporation Number of Returns, by Number of Shareholders and Industrial Sector, available on the IRS website at http://www.irs.gov/taxstats.
[42] See Hoyt, *supra*.
[43] IRC§1371(a) subjects S corporations to all C corporation taxes except as explicitly overridden by the provisions of Subchapter S. See also Treas. Reg. §1.337(d)-4(a).
[44] For an extensive discussion of this issue see "A Hidden Trap for Generous Corporations," by Laura H. Peebles, *Planned Giving Design Center*, published May 2005.

any built-in gain in any of its assets at the time of conversion is subject to tax if the corporation disposes of one of those assets within five years of the conversion.[45] It is clear that the BIG tax is triggered if the corporation sells or distributes the asset to a shareholder. But in a sparsely reasoned private letter ruling, the IRS determined that a gift of an asset to a governmental entity would not trigger the BIG tax.[46] Of course, private letter rulings can be relied on only by the taxpayers who obtained the rulings, but it is possible the IRS views the BIG tax as inapplicable to outright gifts to charities or governmental entities. There appear to be no analogous rulings dealing with the possible application of the BIG tax to transfers to charitable remainder trusts.

Finally, for S corporations that were once C corporations, and which make gifts to term-of-years charitable remainder trusts, care must be taken that difficulties are not encountered with the excess investment income tax provisions of IRC §1375. If an S corporation has accumulated earnings from Subchapter C taxable years, and if the S corporation has net passive investment income that exceeds 25% of its gross receipts for the current taxable year, it might be subject to this tax.[47] An S corporation receiving unitrust payments after a business interest has been sold by a term-of-years unitrust might have excess net passive investment income because the portfolio earnings of the unitrust are likely to be dividends, interest, and other forms of passive investment income. If the S corporation has an excess investment income for three consecutive years, it will lose its S corporation tax status.[48]

Actual Case Study: Gift by S Corporation of Real Estate to Charitable Remainder Trust

Zhang Sang and his wife Lan are in their late 70s. They immigrated to the United States many years ago from Asia and became naturalized United States citizens. They have two residential rental properties that are held in a business entity known as "S&L Enterprises." Sang and Lan are interested in making a contribution of at least one of their rental properties, worth about $2.5 million, to their local community foundation while receiving lifetime income in return. The rental properties are mostly leased, have no debt or environmental problems, and are in good condition.

Further investigation with the Zhangs and their CPA reveals that S&L Enterprises is an S corporation; however, it has functioned as an S corporation from its inception about 20 years ago. Sang and Lan are its only shareholders. Because the S election would be terminated if the Zhangs made a contribution of S corporation stock to a flip charitable remainder unitrust, the CPA and the local community foundation's gift planner explore a potential gift of one of the

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[45] IRC §1374(d)(7). The triggering period used to be ten years, but it was shortened to five years for taxable years beginning in 2011.
[46] See Private Letter Ruling 200004032.
[47] See IRC §1375 and Treas. Reg. §1.1375-1(a)
[48] See IRC §1362(d)(3).

rental properties to a term-of-years flip unitrust. The unitrust payments would be made to S&L Enterprises for a period of 20 years, which exceeds the joint life expectancy of Sang and Lan.

Because S&L Enterprises was never a C corporation, the "BIG" tax and the excess passive investment income tax are not planning roadblocks. Sang and Lan have no children, but it is possible that a great nephew would be interested in purchasing the property. The Zhangs have not entered into any binding sale agreements, so there is no problem with the assignment of income doctrine. Furthermore, a great nephew is not a disqualified person under IRC §4946 and therefore there is no problem with self-dealing excise taxes.

Sang and Lan decide to move forward and cause S&L Enterprises to deed one of the rental properties to a term-of-years charitable remainder unitrust with the community foundation serving as trustee. Although the great nephew encountered some financial difficulty in the recent recession and decided not to purchase the property from the trust, the property was sold several months later for about 95% of the asking price.

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Disclosure

Tax & Legal Information

While the issues in this paper have been carefully researched, neither THE PENNSLVYANIA STATE UNIVERSITY nor KASPICK & COMPANY provides legal or tax advice. Therefore, all readers of this paper and attendees at the presentation are urged to consult qualified legal counsel when engaged in gift planning activities.

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The accuracy of third-party data or research cannot be guaranteed.

Appendix

Gifts of Closely-Held Business Interests

	Nature of Entity	Tax Treatment	Charitable Gift Planning Issues
C Corporation	• Separate entity owned by shareholders • Affords liability protection	• Two layers of tax • Corporation taxed on its income • Shareholders taxed on dividends	• Shares can generally be given outright, for a CGA, or to fund a CRT or CLT • Planning challenges: - Buy-sell agreements / permissible shareholders - Pre-arranged sale - Liquidity to redeem donated interest - Business valuation / valuation discounts / qualified appraisal - Self-dealing (charitable remainder and lead trust gifts only) - Excess business holdings (selected charitable lead trusts) - Unrelated business taxable income (UBTI) in controlled corporation setting (more than 50% ownership by charity)
Limited Liability Company (LLC)	• Separate entity owned by members • Affords liability protection	• Usually taxed as partnership • No tax at LLC level • Tax results “flow through” to members	• Units can sometimes be given outright, for a CGA, or to a CRT or CLT • Planning challenges: - UBTI challenges make these gifts difficult unless LLC owns only debt-free real estate - Bargain sale treatment if donor is relieved of partnership (LLC) debt - Buy-sell agreements / permissible members - Pre-arranged sale - Liquidity to redeem donated interest - Business valuation / valuation discounts / qualified appraisal - Self-dealing (charitable remainder and lead trust gifts only) - Excess business holdings (selected charitable lead trusts)
S Corporation	• Separate entity owned by shareholders • Only one class of stock • No more than 100 shareholders • Affords liability protection	• Generally no tax at corporate level • Tax results “flow through” to shareholders	• Could be given outright, for a CGA, possibly to a CLT, but generally not to a CRT (loss of S election) • Planning challenges: - Automatic UBTI realization on income and gain (outright gifts to charity) - “Hot asset” rules reduce donor’s charitable deduction - Buy-sell agreements / permissible shareholders - Liquidity to redeem donated interest - Business valuation / valuation discounts / qualified appraisal - Buy-sell agreements / permissible members - Pre-arranged sale • S Corporations can contribute assets to charity or term-of-years CRT. Planning challenges: - §1371 built-in gains tax for converted C corporations - Gift by a corporation of “substantially all” its assets triggers tax - §1375 tax on excess net passive income

Note: The authors are grateful to Paul Geidl and Stacey Hall of the LCMS Foundation in St. Louis, Missouri, for the structural design of this chart.