Charitable Gifts of Business Interests

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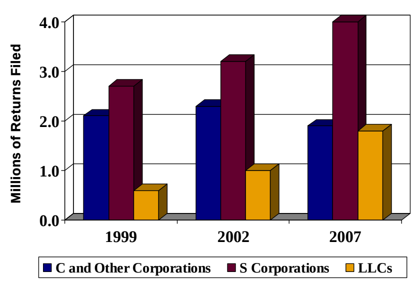
Setting the Stage

- Retire from business
- Make a charitable gift
- Minimize taxes
- Transfer or sell ownership interest to family or employees

- Outright gift
- Remainder trust
- Gift annuity
- Lead trust
- Private foundation
- Donor advised fund

- C corporation
- Partnership
- S corporation
- Limited liability company (LLC)

Trends in Business Ownership



Source: Tax Statistics of the Internal Revenue Service

The Major Planning Issues

	Charitable Gift Asset		
Issues	**C Corp**	**LLC**	**S Corp**
Source of liquidity	●	●	●
Buy-sell agreements	●	●	●
Pre-arranged sale	●	●	●
Business valuation/discounts	●	●	●
Self-dealing	CRT/CLT	CRT/CLT	
Excess business holdings	CLT	CLT	
UBTI	◒	●	●
Partnership rules	○	●	●

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 (CRT and CLT gifts only) - Excess business holdings (most CLTs) - Unrelated business taxable income (UBTI) in controlled corporation setting (more than 50% ownership by charity, CRT, or CLT)
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 the LLC owns only debt-free real estate - Bargain sale treatment if donor is relieved of partnership (LLC) debt - "Hot asset" rules reduce donor's charitable deduction - Buy-sell agreements / permissible members - Pre-arranged sale - Liquidity to redeem donated interest - Business valuation / valuation discounts / qualified appraisal - Self-dealing (CRT and CLT gifts only) - Excess business holdings (most CLTs)
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 or for a CGA but generally not to a CRT (loss of S election) or CLT (partial loss of deduction for payments to charity) • Planning challenges: - Automatic UBTI characterization of income and gain (outright gifts to charity); consider an electing small business trust (ESBT) to reduce tax liability on qualifying dividends and gain - "Hot asset" rules reduce donor's charitable deduction - Buy-sell agreements / permissible shareholders - Pre-arranged sale - Liquidity to redeem donated interest - Business valuation / valuation discounts / qualified appraisal • S Corporations can contribute assets to charity or term-of-years CRT. Planning challenges: - Gift by a corporation of "substantially all" its assets triggers tax - §1371 built-in gains tax for converted C corporations - §1375 tax on excess net passive income of converted C corporations

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.

Case Studies

- Outright gift of C corporation stock to charity
- Gift of interest in LLC to a charitable lead trust (CLT)
- Life income gift involving an S corporation

An objective in the first two cases was for family members to own a controlling interest in the business when the gift was complete

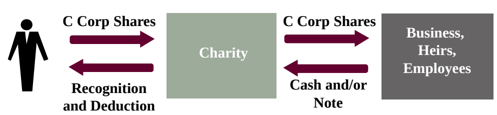
Outright Gift of C Corporation Stock

Case Study Situation

- Bill and Bonnie Rainier control a very successful closely-held business structured as a C corporation
- Using annual exclusion giving and gift tax exemptions, they have given about 35% of the company to their children; an employee stock ownership plan (ESOP) owns about 10%
- Bill and Bonnie want to participate in the university's capital campaign

Gift Strategy

Outright Gift Followed by Redemption or Purchase



Source of liquidity
Buy-sell agreement
Pre-arranged sale
Business valuation

Buy-Sell Agreements

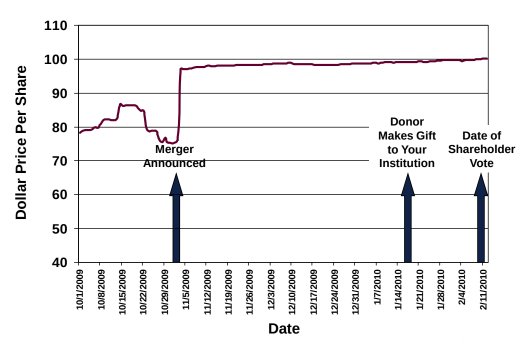
- Provide a roadmap for what will happen when an owner disposes of an interest in the business
- Specify allowable shareholders
- Set forth price and payment terms
- Describe how buyouts will be funded (*e.g.*, with insurance proceeds upon the death of an owner)
- Contain non-compete agreements

Pre-Arranged Sale

- *Palmer v. Commissioner* (1974) and Revenue Ruling 78-197—A "bright line"
- *Blake v. Commissioner* (1982)—Illustrated how to cross the bright line
- *Ferguson v. Commissioner* (1999)—Stock "ripens into a fixed right to receive cash"
- *Rauenhorst v. Commissioner* (2002)—IRS cannot argue against its own "bright line"

Economically a "Done Deal"?

Closing Prices of Burlington Northern Stock



Business Valuation

- Purchasers want to pay an appropriate price for the business interest
- Charities (and CRT trustees) want to realize a fair value
- Donors can have conflicting interests
  - Low value for transfer tax purposes
  - High value for income tax deduction
- Qualified appraisal and discounts for minority interest and lack of marketability

Self-Dealing Rules (CRT and CLT Only)

- Excise taxes on transactions between disqualified persons and the trust
- Disqualified persons
  - Donors, their lineal ascendants or descendants, and their spouses
  - Trusts, corporations, partnerships more than 35% owned by these persons
- Exception for redemption of stock if…
  - At fair market value
  - Same offer extended to other shareholders of same class

Case Study Outcome

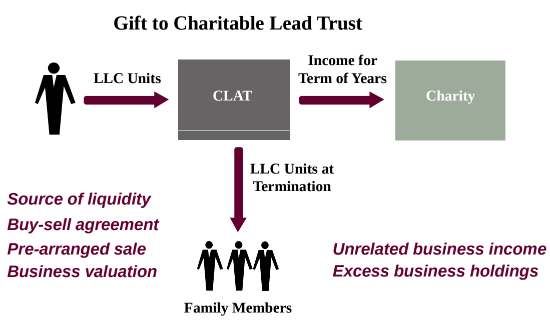
- The redemption price for the Rainier's stock was set forth in buy-sell agreement
- The gift was made to a subsidiary charity
- There was no binding agreement for charity to surrender shares
- The qualified appraisal reduced the gift valuation for lack of marketability and minority interest
- After the gift, the children were close to owning a controlling interest

Gift of LLC Units to Charitable Lead Trust

Case Study Situation

- Steve and Margaret Lyons own two commercial properties in an LLC
- They want their children to inherit the properties
- Steve is a member of the university's Campaign Leadership Council
- The Dean of the Engineering School would like the Lyons to endow a chair
- The CFMR is 1.8% in December of 2010

Gift Strategy



Unrelated Business Taxable Income

- Definition—income from a trade or business that is unrelated to the charity’s exempt purpose and is regularly carried on
- UBTI for charitable entities
  - Charities pay tax at corporate or trust rates
  - CRTs pay tax at 100% rate
  - CLTs lose the normal 642(c) deduction for payments to charity and instead get a percentage of AGI deduction

Exceptions to UBTI

- Dividends, interest, royalties
- Rents from real property not based on a percentage of profits
- Capital gain from investments

The presence of debt can turn income items otherwise qualifying for the exceptions into unrelated business taxable income

Excess Business Holdings Excise Tax

- Applies to a CLT when the charitable interest is greater than 60% of the trust’s value
- Tax generally applies to holdings in a business by a CLT and its related disqualified persons that exceed a permitted 20% of voting stock threshold
- Exception for business enterprises that derive more than 95% of their income from passive sources

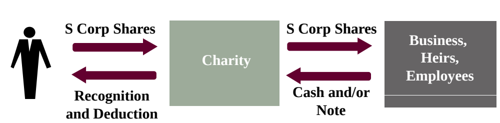
Case Study Outcome

- Neither of the Lyons properties has debt
- Properties in excellent locations and subject to ground leases
- Steve and Margaret added cash to the CLAT along with the LLC units to provide liquidity for anticipated repairs during the CLAT term
- Detailed contingency plans were put in place and shared at a family meeting

Gift Involving an S Corporation

Gift Strategy

Outright Gift Followed by Redemption or Purchase



Source of liquidity
Buy-sell agreement
Pre-arranged sale
Business valuation
Special UBTI rules
Partnership rules

S Corporation Stock—Gift Obstacles

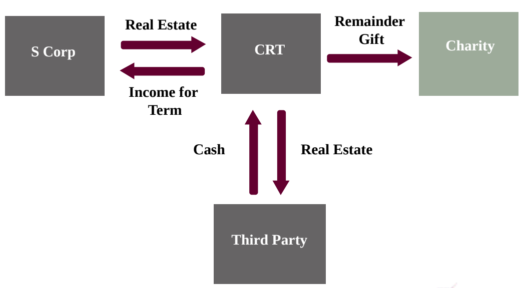
- ***All*** items of income derived from S corporation stock are taken into account when computing UBTI for a charity
- Capital gain on the sale of S corporation stock is also UBTI to the charity
- “Hot asset” rules generally result in a reduced charitable deduction for the donor
- CRTs are not eligible shareholders of S corporation stock

Case Study Situation

- Zhang Sang and his wife, Lan, own multiple residential rental properties in an S Corporation, S&L Enterprises. They have no children
- They want to make a gift to their local community foundation
- The properties have no debt, are mostly leased, and are in very good condition
- The Zhangs would like to receive an income from their gift

Gift Strategy—S Corp as Donor

Gift to CRT Followed by Redemption or Purchase



Case Study Outcome

- S&L Enterprises did not convert from a C corporation to an S corporation in its past
- S&L contributed *one parcel* of real estate worth approximately $2.0 million to a term-of-years CRT
- There are no binding agreements to sell
- A great nephew might be interested in purchasing the property, but he is not a disqualified person

Disclosures

Thank You!