Strategically Giving a Business Interest to Charity

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Introduction

A charitable gift of an interest in a closely held business requires careful planning. The intent of the donor is valued but the complexity of the gifting needs to be viewed to provide the maximum benefit for both the charitable organization and the donor. Charitable organizations want to be considered to receive donations. However, illiquid assets often present a challenge, particularly interests in an operating business (unlike an interest in a private equity fund or a hedge fund). The advantage for the business owner/taxpayer is the avoidance of capital gains tax. Generally, pursuant to Sec. 170 and Regs. Sec. 1.170A-1(c)(1), a taxpayer may deduct the fair market value of appreciated property donated to a qualified charity without recognizing the gain in the property. However, there is an attraction to the potential recurring income that may be received from owning a business interest. If a transaction is not properly planned, a greater tax liability can be experienced than benefited.

The considerations in strategically planning for the transfer of closely held business interests to benefit both the charitable organization and the donor incorporate the valuation, business structure and timing to determine the impact of the gift. Among other concerns, the charity must have clarity regarding the unrelated business income tax. In the case of an interest in an active business, the tax benefit of a charitable donation can usually be optimized at a time when the entity is performing at or near its historical high. A fair market value deduction that captures enterprise value and untaxed appreciation of tangible assets can result in greater tax savings than the contribution of the proceeds of a sale of the business interest or from the liquidation of its underlying assets.

I. Business Structures

Sole Proprietorships

Private foundation is not permitted holdings in sole proprietors that are business enterprises unless they were held before May 26, 1969 or acquired by gift or bequest thereafter.

Partnership interests

Transferring a partnership interest requires specific considerations for both the donor and the charity. The general rule is gain from the sale or exchange of a partnership interest is considered gain from the sale of a capital asset (§741). The contribution of property to a qualifying charity is deductible at fair market value, except for gain that would not be treated as long-term capital gain if the property had been sold at its fair market value on the date it was contributed (§170(e)(1) and Treas. Reg. §1.170A-1(c)(1)). However, the deduction for long-term capital gain property contributed to a private foundation, other than an operating foundation, is generally limited to the lesser of fair market value and cost or other basis of the property.

If a partner is relieved of any debt as a result of the transfer of a partnership interest, it is treated as an amount realized (§752(d)). While the relief of debt does not provide any immediate consideration to a transferring partner, the elimination of a liability improves the partner's economic position. In addition, if the debt was included in the partner's at-risk amount, the

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partner has either received an equivalent tax benefit from past partnership deductions or will receive an offsetting deduction of such remaining basis allocable to a sale.

Under the partial interest rules generally applicable to gifts of property, the donor of a partnership interest must give charity his or her entire interest or an undivided portion of that entire interest. Otherwise, no deduction will be allowed. An undivided portion of a donor's partnership interest must be expressed as a fraction or percentage, so it includes a pro rata share of each and every attribute of the interest, such as capital, allocation of income and expense, and distributions.

As with any charitable gift of property, a gift of a partnership interest subject to liabilities may be treated as a bargain sale, resulting in the donor's recognition of taxable gain. The donor will be deemed to have sold his or her partnership interest to the extent of his or her allocable share of liabilities; his or her basis in the partnership will be allocated pro rata between the amount treated as sold and the amount treated as a charitable contribution.

Losses that arise from activities in which a partner did not materially participate (including most limited partner interests) may be claimed as losses by a partner only to the extent of income or gain from those activities or upon a qualifying disposition of the passive activity. A charitable contribution of a partnership interest is not a qualifying disposition for these purposes, and a donor will not be able to take a deduction for suspended passive activity losses.

An individual with suspended passive activity losses from a partnership should consider whether he or she would be better off selling the partnership interest, deducting the losses, and donating the net proceeds to charity rather than donating the partnership interest itself.

Corporations

Corporations are business structures that are established under the Internal Revenue Code. C Corporations are the default designation, which is defined under Subchapter C of the Internal Revenue Code. Corporations offer limited liability protection for the shareholders. Therefore, the owners are not typically personally liable for business debts and liabilities. Corporations are established through state law. The corporations are registered by states. The state makes no differentiation in the compliance responsibilities.

C Corporation status is the standard or default corporation structure as defined by the IRS rules. The taxation, which is described in Subchapter C of the Internal Revenue Code, is applied at the corporate level as well as at the individual level for dividends that are distributed to shareholders. C corporations are separately taxable entities that file a corporate tax return (1120) and pay taxes at the corporate level. Taxes are also paid at the individual level when dividends are paid to the shareholders. C corporations have no restrictions on ownership.

Subchapter S of the Internal Revenue Code provides an alternative taxation methodology for the corporation beyond the C Corporation. The S Corporation is treated like a corporation with distinctive differences. Principally, the taxation is passed directly to the shareholders, avoiding the double taxation. The S corporation files an annual Form 1120S as an information form that is "passed through" to the owners' personal tax returns. S corps are restricted to no

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more than 100 shareholders, and shareholders must be US citizens/residents. In 1998, charities could also own S corporation stock. Ineligible shareholders of S corporation could jeopardize the Subchapter S status.

Charitable Remainder Trust cannot receive or hold S corporation stock, but a charitable lead trust can.

Charitable Organization Structure

If the charitable organization is a private foundation or a donor advised fund, the application of the excess business holdings rules must also be considered. If the private foundation/donor advised fund holds more than 20 percent of the donated business (both as a percentage of value and voting) the excess business holdings rules become a consideration.

The IRS defines excess business holdings of a private foundation as the amount of stock or other interest in a business enterprise that exceeds the permitted holdings. A private foundation is generally permitted to hold up to 20 percent of the voting stock of a corporation, reduced by the percentage of voting stock actually or constructively owned by disqualified persons. There are two exceptions to this rule.

If one or more third persons, who are not disqualified persons, have effective control of a corporation, the private foundation and all disqualified persons together may own up to 35 percent of the corporation's voting stock. Effective control means the power, whether direct or indirect, and whether or not actually exercised, to direct or cause the direction of the management and policies of a business enterprise. It is the actual control which is decisive, and not its form or the means by which it is exercisable.

A private foundation is not treated as having excess business holdings in any corporation in which it (together with certain other related private foundations) owns not more than two percent of the voting stock and not more than two percent of the value of all outstanding shares of all classes of stock.

Nonvoting stock (or capital interest for holdings in a partnership or joint venture) is a permitted holding of a foundation if all disqualified persons together hold no more than 20 percent (or 35 percent as described earlier) of the voting stock of the corporation. All equity interests which are not voting stock shall be classified as nonvoting stock.

A private foundation that acquires excess business holdings, other than as a result of a purchase by the foundation, will not be subject to the taxes on excess business holdings if it disposes of the excess business holdings within 90 days from the date on which it knows, or has reason to know, of the event that caused it to have the excess holdings. This 90–day period will be extended to include the period during which a foundation is prevented by federal or state securities laws from disposing of the excess business holdings. The 90–day disposition period applies, for example, when a disqualified person acquires additional holdings. The amount of holdings the foundation must dispose of is not affected by disposals by disqualified persons during the 90–day period.

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In the case of gifts and bequests, there is a five-year "grace period" to bring holdings within permitted levels, and in special cases, the IRS may exercise its discretion to grant one or more extensions.

II. Valuation

In evaluating a potential gift of Subchapter S stock to charity, a donor should be aware of the types of assets held by the corporation, especially appreciated inventory or unrealized receivables. A fair market value charitable deduction for the gift of appreciated stock must be reduced by the amount of "ordinary income" the donor would have recognized if he or she had sold the property. Code Section 170(e)(1) provides that "rules similar to the rules of [Code] section 751 shall apply in determining whether gain on [S corporation] stock would have been long-term capital gain if such stock were sold by the taxpayer." Consequently, the donor's deduction for a contribution of Subchapter S stock, in most instances, will not be the full fair market value of the stock, but will be reduced to the extent of the donor's share of the corporation's appreciated inventory and unrealized receivables, including depreciation recapture.

The IRS has specific details regarding valuation.

- Reg. §§ 25.2512-3(a)- Valuation of interests in business
- Rev. Rul. 59-60, 1959-1 CB 237 – "In valuing the stock of closely-held corporations where market quotations are not available, all other available financial data, as well as all relevant factors affecting the fair market value must be considered for estate tax and gift tax purposes."
- Rev. Rul. 65-193, 1965-2 CB 370 – Separate appraisals needed to value the tangible and intangible assets of a business
- Rev. Rul. 77-287, 1977-2 CB 319 – Deals with securities that cannot be immediately resold because they are restricted from resale pursuant to Federal securities laws
- Rev. Rul. 80-213, 1980-2 CB 101 – Valuation of stock of a subsidiary corporation that may only be sold with shares of the parent organization (i.e., "paired" stock)
- Rev. Rul. 83-120, 1983-2 CB 170 – Factors to consider in valuing common and preferred stock of a closely-held corporation

Charities usually are reluctant to accept gifts of Subchapter S stock because all items of income and gain allocable to the charity during the period it holds the stock (including the gain on disposition of the shares) will constitute unrelated business taxable income (UBTI) and will be taxable in its hands. These rules generally are less favorable than the rules for gifts of partnership interest, discussed below. A donor of Subchapter S stock should expect the charitable donee to want assurances there will be adequate distributions from the corporation to cover the charity's potential tax liability.

One alternative may be for the Subchapter S corporation itself to donate assets to charity. The gift is treated as if made on a pro rata basis by the shareholders and is subject to their individual contribution limits. Generally, the shareholder's basis in his or her shares is reduced pro rata by the shareholder's share of the corporation's basis in the property contributed to

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charity, and the charitable deduction available to the shareholder for gifts by the corporation is limited to the basis in his or her shares.

The charity must assign a fair market carrying value for financial reporting purposes. A closely held corporation has an ambiguous fair market value. IRS Revenue Ruling 59-60 guides the valuation. In business valuation terms, fair market value (FMV) is a "standard of value". Since the meaning of "value" can depend on the person and context, the standard of value defines the type of value being sought by addressing: "value to whom?" and "under what circumstances?" (Pratt, *Valuing a Business.* 5th ed.) While there are other standards of value (e.g., fair value, investment value, intrinsic value), fair market value is considered the most widely recognized and accepted standard of value related to business valuations. It is the standard that applies to virtually all federal and state tax matters such as federal estate taxes (Form 706), gift taxes (Form 709) and even inheritance and income taxes. As such, fair market value is the standard of value required by the IRS for IRA valuations. The International Glossary of Business Valuation Terms provides the following definition of "fair market value":

"The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts."

Pursuant to IRC §170(f)(11)(C), taxpayers claiming a deduction of more than $5,000 are required to obtain a qualified appraisal and attach to the return such information regarding such property and such appraisal as the Secretary may require, which includes a fully completed appraisal summary on Form 8283. If the contribution is valued at more than $500,000, the taxpayer must also attach a copy of the qualified appraisal to the return in addition to the other requirements. (§170(f)(11)(D)). For these purposes, a "qualified appraisal" must be performed by a qualified appraiser and must contain (among other things): 1) a detailed description of the property sufficient for a person who is not generally familiar with the property to ascertain that the property appraised is the property that was contributed; 2) a statement that the appraisal was "prepared for income tax purposes"; 3) the date of the contribution; 4) the date of the appraisal; and 5) the appraised fair market value. (Treas. Reg. §1.170-1(c)(3)(ii)).

In 1959 the IRS issued Revenue Ruling #60 as guidance on how to credibly value a closely held business. This standard has not been revised. This Ruling, more commonly known as Revenue Ruling 59-60, suggests a review of the following:

- The nature of the business and the history of the enterprise from its inception;
- The economic outlook and the conditions and outlook of the specific industry in particular;
- The book value of the stock and the financial condition of the business;
- The earning capacity of the business;
- The dividend-paying capacity;
- Whether or not the enterprise had goodwill or other intangible value;
- Prior sales of the stock and the size of the block of stock to be valued; and
- The market price of stocks and the sizes of companies engaged in the same or a similar line of business having their stocks actively traded on an exchange or over-the-counter market

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The above factors form the basis for developing a fair market value indication based on the utilization of three basic approaches to value: Market, Income, and Cost approaches, briefly defined as follows:

- Market Approach – Based upon the valuation principle of substitution, as it develops value measures from prices investors are paying for stocks of similar publicly traded companies.
- Income Approach – Based upon the valuation principles of anticipation and substitution, as the approach considers expected returns on an investment, which are either discounted or capitalized at an appropriate rate of return to reflect investor risks and hazards.
- Cost Approach – This approach uses balance sheet data at or near the valuation date adjusted to reflect the estimated market values of the assets and liabilities. A net asset value is then derived by subtracting the recorded liabilities from the estimated fair market values of the underlying assets.

The complexity of determining the fair market value necessitates the employ of a competent business appraiser. Regulations require a qualified business valuator. This cost should be factored into the planning for the charity. The added costs, including the additional tax reporting should be structured into the cost/benefit analysis for the charity in accepting ownership of the gift.

The strategic planning for gifts of closely held C corporations should be distinctive from that of S corporations. The approach of "gift followed by redemption" works well with C corporations. "The Gift Followed by Redemption" strategy is when an appreciated asset that typically would be subjected to capital gains tax is donated to a charity, which would not be subjected to capital gains tax, after which the asset is redeemed and its value realized. With S corporations, it would be more effective for the corporation to contribute some of its appreciated assets rather than have the shareholder contribute some of his/her stock. The transaction flows through to the shareholder's tax return. Thus, if an S corporation makes a simple cash gift to a charity, the charitable income tax deduction will be claimed on the *shareholder's tax return*. There is no need for the shareholder to contribute stock to obtain a charitable tax deduction when the corporation's gifts can produce these tax benefits to the shareholder, often at less cost since there is no need to pay to have the stock's value appraised.

The charity benefits from receiving donations of appreciated assets. The charity does not pay capital gains tax and receives the assets at their fair market value. The charity is often excited to receive an operating business that produces ongoing revenue. However, the charity will have to pay taxes on the revenue of unrelated business income tax (UBIT). UBIT is revenue generated by activities that are unrelated to the tax-exempt purpose of the organization. By comparison, when a shareholder of the S corporation contributes stock, a charity has a UBIT liability for the income attributable to the days and/or years that it was a shareholder of an S corporation as well as a UBIT liability for the gain on the ultimate sale of the stock.

III. Timing

The goal is to gift the business interests before entering into a binding agreement to sell to secure "double" tax benefits of (a) obtaining a charitable income tax deduction to help offset gain realized by the donor, while (b) avoiding, or at least significantly reducing, tax on the

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proceeds to the charity. This strategy is beneficial if the individual donor holds business interests with low basis that would result in a significant long-term capital gain if the business were sold. If the interest is gifted prior to sale, the donor would obtain a charitable income tax deduction equal to the fair market value of the gifted interest, which first offsets higher taxed income, and the donor avoids tax on the interests gifted. In many cases, the charity will not pay unrelated business income taxes (known as UBIT) upon the subsequent sale of the business interest. For taxpayers who are potentially subject to the "net investment income tax" on passive income (under Internal Revenue Code Section 1411), the tax of 3.8% is not imposed on gain realized by the charity.

A charitable gift is made when the properly endorsed and transferable stock is delivered to the institution or agent for the institution. If the gifting of the stock is concurrent or in a short time span in relation to the sale of the business, the IRS takes the position that the sale of the property was by the donor, and the gift was one of the proceeds to the charity. The doctrine says that two or more seemingly independent transactions are consolidated and treated as a single transaction

The tax treatment will also require factoring the timing of the gifting. The assignment of income doctrine is a doctrine where the IRS seeks to prevent someone who earns income from shifting that income to another taxpayer who may be in a lower tax bracket (or exempt from tax). The supreme Court has held in Basye, *U.S. v. Basye*, 410 U.S 441 (1973), "he who earns income may not avoid taxation through anticipatory arrangements no matter how clever or subtle" and a person expecting income cannot avoid taxation by entering into a contractual arrangement whereby that income is diverted to some other person. In this case, the timing of the transaction is a significant finding to the IRS. The timing between the contribution to the charity and the sale was an indication of the prearrangement between the donor and the charity. To avoid triggering capital gains for the donor, the arrangement should not be a prearranged plan that the charity will sell the property to a specific buyer.

Pursuant to IRC §170(f)(11)(C), taxpayers claiming a deduction of more than $5,000 are required to obtain a qualified appraisal and attach to their return such information regarding such property and such appraisal as the Secretary may require, which includes a fully completed appraisal summary on Form 8283. If the contribution is valued at more than $500,000, the taxpayer must also attach a copy of the qualified appraisal to the return in addition to the other requirements. (§170(f)(11)(D)). For these purposes, a "qualified appraisal" must be performed by a qualified appraiser and must contain (among other things): 1) a detailed description of the property sufficient for a person who is not generally familiar with the property to ascertain that the property appraised is the property that was contributed; 2) a statement that the appraisal was "prepared for income tax purposes"; 3) the date of the contribution; 4) the date of the appraisal; and 5) the appraised fair market value. (Treas. Reg. §1.170-1(c)(3)(ii)).

The timing of the gift in relation to the determination of selling the property is significant. If there is a legally binding commitment to sell the asset, the donor must recognize the gain on the sale and treat the gift no different than a gift of cash. If there is any indication of the commitment, such as a letter of intent, the process may have advanced too far for the donor to avoid recognizing gain on the sale.

Tips and Take Aways

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A. *An S corporation can own S corporation stock since 1998 as a result of a change of law.* As may some forms of charitable lead trusts. However, a charitable remainder trust cannot own S corporation stock.

B. *The donor's tax deduction is usually less than the appraised value of the stock.* Congress made the tax deduction for a gift of S corporation stock comparable to a gift of a partnership interest rather than a gift of Subchapter C corporation stock. Consequently, a donor is required to reduce the deduction by the amount of *ordinary income* that the donor would recognize if the S corporation's assets were liquidated (that is, the portion of a hypothetical gain from selling inventory, assets subject to depreciation recapture, and other ordinary income assets). For most donors, this adjustment does not significantly affect the amount of the charitable tax deduction.

The last sentence of section 170(e)(1) (relating to income tax charitable deductions for contributions of ordinary income and capital gain property) states: *"For purposes of applying this paragraph in the case of a charitable contribution of stock in an S corporation, rules similar to the rules of section 751 shall apply in determining whether gain on such stock would have been long-term capital gain if such stock were sold by the taxpayer.*" Congress therefore imported the "hot asset" rules, which determine the amount of ordinary income versus capital gain that partners have when they sell their partnership interests. By comparison, when a shareholder *sells* S corporation stock instead of contributing it to a charity, the partnership hot asset rules that apply to the sale of a partnership interest do not apply to the sale of stock. Instead, all of the gain is classified as capital gain. The partnership hot asset rules only apply to a charitable donation of S corporation stock and not a sale.

C. *For every day that the charity owns the stock, the charity must report its share of the corporation's income as unrelated business taxable income ("UBTI") and must pay the unrelated business income tax ("UBIT").* The tax treatment is worse than a comparable gift of a partnership interest. A charity does not pay UBIT on its share of a partnership's passive investment income, such as interest or capital gains, but it will have to pay UBIT on such income earned by an S corporation. In 2003, nearly 20% of all S corporation income was from such investment sources.

D. Normally a charity does not have UBTI when it sells stock from its investment portfolio for a profit, but a sale of appreciated S corporation stock will trigger a UBIT liability.

Sec. 512(e)(1)(B)(ii) overrides this exemption: "notwithstanding any other provision of this part... any gain or loss on the disposition of the stock in the S corporation shall be taken into account in computing the unrelated business taxable income of such organization."

In fact, the tax liability incurred by a charity can often be greater than the tax liability that the donor would have incurred had the donor sold the stock. Whereas most individuals are subject to a maximum federal tax rate of only 15% on their long-term capital gains (it can be 20% for taxpayers with taxable income of roughly $500,000 or more), incorporated charities receive no tax break for long-term capital gains and pay UBIT at ordinary corporate rates, which can be as high as 21%. Thus, if there is a $100,000 gain, the shareholder likely would have paid only $15,000 federal tax on the sale but the charity that receives the stock as a gift must pay a tax

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as high as $21,000. By comparison, a charity that is a trust rather than a corporation can pay the same low 15% rate as the donor.

E. Other shareholders impact. The impact on the ownership status as a result of the charitable ownership.

F. Non grantor Charitable Lead Trust is permitted to be a shareholder of an S corporation if the trust makes a small business trust election. This election creates undesirable income tax results, and the trust will be denied a charitable deduction for the S corporation income the trust distributes to the charity.

G. Transfers of 50 percent or more of a partnership during one year may lead to a technical termination of the partnership.

H. A donation of debt-financed property may produce UBTI for the recipient charity.

I. A disposition of low-basis S corporation shares by a charity (which stands in the shoes of the donor with regard to basis) could lead to substantial tax liability, since realized gains will be taxed as UBTI.

J. A donation of an interest in a closely held entity to pooled income funds or charitable remainder trusts are fraught with potential dangers and should be planned with extra care. No charitable gift of shares in a closely held enterprise should require redemption as a condition of the gift.

K. A donation of Section 306 shares, or of shares in a “collapsible corporation” may result in lower than FMV contributions since the value of such contributions must be reduced by the amount of ordinary income that would have been realized by the donor upon their sale.

L. A donation of a successor or remainder interest in an LLC that owns real estate subject to a long-term lease may create problems. The IRS and Treasury released Notice 2007-72 to indicate their growing interest in a transfer that generates an excessive deduction (especially when compared to the price the donor paid for the interest).

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