

Charitable Gifts of Closely Held Business Interests

A Guide

Community Foundation

FOR SOUTHEAST MICHIGAN

Table of Contents

- 3 Deductible Charitable Contribution for Gift to Public Charity
- 4 General Overview
- 7 Charitable Gifts of Interests in Pass-Through Entities
- 8 Charitable Gifts of S Corporation Stock
- 9 Charitable Gifts of C Corporation Stock
- 9 Deductible Charitable Contributions to Private Foundations and Charitable Trusts
- 10 Conclusion

Community Foundation

FOR SOUTHEAST MICHIGAN

The Community Foundation is experienced in accepting gifts of closely held business interests, and we can work with you and your clients to make the gifting process straightforward and efficient, consistent with your clients' business and estate planning goals.

We know southeast Michigan and nonprofits in our region. We can work with you and your clients to advise you about grantmaking to organizations locally and nationally.

Charitable Gifts of Closely Held Business Interests

Laura Brownfield, General Counsel, The Community Foundation for Southeast Michigan

This article originally appeared in the Michigan Prob & Est Plan J, Vol. 39, at page 10, and is reprinted with permission

For an individual holding illiquid securities - often highly appreciated, with a low-cost basis, and a significant current fair market value – a transfer to a public charity is an opportunity to receive an immediate income tax deduction while supporting charity. By gifting business interests to charity a donor can reduce or eliminate capital gains tax, creating more charitable dollars following the redemption of the interest and a greater ability to accomplish his charitable intentions than if he sold the interests and donated the cash proceeds.

The availability and the amount of the income tax deduction depend in part on the type of property being transferred, the tax basis of the property, and the nature of the donee. The timing of the donation, the structure of the transaction, and the documentation of the transfer require planning well in advance of the gift.

Practitioners working with philanthropically inclined individuals who own interests in closely held businesses should consider the tax advantages associated with a transfer of such interests to a public charity (including a donor advised fund). This book gives a broad overview of the issues involved when an individual wants to make a charitable gift to a public charity with illiquid business interests.

Deductible Charitable Contribution for Gift to Public Charity

Generally, the amount of a charitable deduction for a contribution of non-cash assets such as closely held C- and S- corporation stock, limited liability company interests, or limited partnership interests is the fair market value of the gifted property reduced by the amount that would be ordinary income or short-term capital gain if the interest was sold at its fair market value.¹ Thus a donor who transfers interests held for more than one year to a public charity can claim a charitable deduction for the contribution based on its fair market value (not its cost basis), avoiding paying tax on the capital gain.

A donor who itemizes can deduct charitable contributions of appreciated closely held business interests in an amount equal to up to 30% of the taxpayer's adjusted gross income.² This applies to gifts to public charities, including donor advised funds.³ Any unused deduction can be carried forward for the succeeding five years.⁴

1 Internal Revenue Code ("IRC") 170(e)(1).

2 IRC Section 170(b)(1)(B).

3 IRC Section 170(c).

4 IRC Section 170(b)(1)(B).

General Overview - Charitable Gifts of Closely Held Business Interests

The reduction in tax liability is a compelling reason for individuals to divest themselves of ownership interests in closely held businesses in advance of a sale or liquidity event. Both the practitioner on behalf of the donor and the charity must consider a number of issues in negotiating and structuring the gift transaction to ensure maximum tax and charitable benefit and to avoid inadvertent consequences.

Can the business owner gift the interest to the charity?

A transfer of a beneficial interest in a closely held business must be made consistent with any agreement among the donor, the owners, and the entity. The parties to the gift transaction should identify restrictions on the donor's ability to transfer the interests to a nonprofit and consider timing requirements and whether consents of other owners or the entity is required. It is also important for the charity to determine who the other member owners are as upon acceptance of the gift of the membership interests, the charity will be entering into business with the other members. The charity will have to assure itself that there is no conflict of interest between the charity and any one or more of the members.

Practitioners should be aware of the impact that the charity's ownership of the business interest will have on the entity and other owners, i.e. governance issues, voting requirements. The charity will also consider cash flow requirements and the obligation of the charity to make additional capital contributions or other payments in determining whether to accept a gift of closely held business interests.

For stock acquired from incentive stock options or an employee stock purchase plan, the donor should confirm that he has met the special holding periods for such stock. Executives and directors will also want to review SEC requirements before gifting company stock.

What is the nature of the underlying business?

The charity has an obligation to protect the investments of other donors, thus an understanding of the underlying operating business, its assets, and its debt, is critical in advance of negotiating the gift transaction. The charity will be concerned about whether there is potential exposure for liabilities, e.g. a business that owns real estate may have environmental issues and a site assessment may be necessary. While the charity may not be deemed an "owner" for federal or state environmental law purposes, it may be deemed an "operator" of the property, thus a charity may undertake environmental due diligence before accepting an interest in an entity owning real property. In addition, the charity will need to anticipate its pro-rata share of any existing debts and liabilities going forward.

What is the percentage of beneficial interest being transferred to the charity?

If the business owner desires to transfer the closely held interests to either a donor advised fund or a private foundation, the parties must be aware of the excess business holding rule.⁵ This rule is to prevent tax-exempt organizations from competing unfairly with taxable businesses.

Under this rule, the holdings of a donor advised fund (sponsored by a public charity) or a private foundation, together with the holdings of persons who are disqualified persons with respect to the donor advised fund (or the private foundation), may not exceed 20% of the voting stock of a corporation.⁶ Nonvoting stock is permitted, but only if all disqualified persons together do not own more than 20% of the voting stock. Similar rules apply to the holdings (profit or capital interest) in pass-through entities. The threshold increases to 35% if it can be shown that persons who are not disqualified persons (i.e. third parties) have effective control of the business.⁷ The donee will have five years to divest holdings that are above the permitted amount, with the possibility of an additional five years if an extension to hold the assets is approved by the Internal Revenue Service ("IRS").⁸

Can the individual retain any portion of the beneficial interests being transferred to the charity?

Generally, charitable contributions of partial interests in business entities made outright to a public charity are not deductible. Deductions are generally allowed only for gifts of complete interests.⁹ Therefore, a public charity will not accept an income interest nor can the donor retain voting rights of interests transferred to a charity. The donor must give his entire interest or an undivided portion of that entire interest (i.e. capital, allocation of income and expense, distributions, voting rights) to charity in order to receive a charitable income tax deduction.

Has the business owner signed a binding letter of intent or purchase agreement?

Gifts of business interests to charity are often prompted by an anticipated event like the sale of a business or an acquisition of interests through a merger. Just as the timing when selling a business impacts the sales price, likewise timing the donation impacts the value of the gift.

A gift to a charity must occur prior to a binding agreement of sale of the business or underlying assets, prior to significant action by the board or management obligating the entity and its owners to the sale transaction, and in the case of IPO shares, either during or after the lock-up period. There cannot be an obligation of the entity to

⁵ IRC Section 4943.

⁶ IRC Section 4943(c)(2)(A).

⁷ IRC Section 4943(c)(2)(B).

⁸ IRC Section 4943(c)(6) and (7).

⁹ IRC Section 170(f)(3).

acquire, or an obligation by the charity to sell back, the interest to the acquiring entity. The inquiry is whether the prospective sale or disposition of the interest is a mere expectation or a certainty. The documentation of the sale must not have proceeded to the point where the IRS could challenge the transaction as a prearranged sale which could result in the IRS treating the gift as an anticipatory assignment of income by the donor, and taxing the donor on the gain generated on the sale, even though the sale occurs after the donor has transferred the business interests.¹⁰

When does the entity intend to consummate the sale transaction?

Such interests are generally appropriate to give to charity when a sale, exchange, or buyback program enable the charity to convert the illiquid interest into cash. It must appear that the beneficial interests donated to the public charity will be sold or converted into income-producing property within a reasonable period of time. Treasury Regulations require that a public charity assures that its funds produce a reasonable return of net income.¹¹ If the donor intends that the charity hold the interests for a period of time, the charity must consider the exit strategy and perhaps a buy-sell agreement to address governance issues following the acquisition of the interests.

How does the owner determine fair market value as of the date of the gift?

The owner must substantiate the gift by obtaining a qualified appraisal complying with IRS regulations establishing the value of the gift.¹² Generally, the threshold for a gift of business interests subject to appraisal is \$5,000.¹³

The IRS takes the position that the same valuation discounts sought by donors of noncharitable gifts also apply to charitable gifts. If a minority interest in a business is transferred to a charity, a minority interest discount should be applied in determining the amount of the charitable deduction. Gifts of such interests are subject to the "qualified appraisal" rules.

The owner may need to file an IRS Form 8283 which includes a signed declaration by the valuation professional relating to the accuracy of the valuation in order to claim an income tax deduction for the gift. If the donated property is listed on IRS Form 8283 is sold, liquidated, or otherwise disposed of within three years of receipt, the charity is required to report separately to the IRS by filing a Form 8282 and disclose facts about the disposition.

What are the unique considerations for gifts of interests in entities engaged in passive or active businesses?

Most charities will accept interests in passive, investment-type entities, such as those

10 For case law regarding this issue see *Kinsey v. Commissioner*, 477 F.2d 1058 (2d Cir. 1973), *aff'd* 58 T.C. 259 (1972); *Ferguson v. Commissioner*, 108 T.C. 244 (1997), *aff'd*, 174 F.3d 997 (9th Cir. 1999);

11 Treas. Reg. Section 1.170A-9(f)(11)(v)(F) and 1.170A-9(f)(13)(x).

12 IRS Publication 561 (Rev. April 2007).

13 *Id.*

holding rental real estate, stocks, bonds, and other investments, subject to the excess business holdings rule. Charities may be reluctant to accept interests in active, for-profit businesses, as active trade or business income and gain will be taxable to the charity during its ownership.

Additional consideration must be given to whether all or part of the entity's income and gain constitutes unrelated business taxable income ("UBTI"). UBTI is income from activities that: (1) are regularly carried on, (2) rise to the level of a trade or business, and (3) are not substantially related to the charity's exempt purposes.¹⁴ The charity will pay taxes on such income. UBTI does not include passive income such as dividends, interest, most rents from real property, and gains from the sale of property.¹⁵ Practitioners should be prepared for the charity to request assurances that the distributions it will receive from the entity will be sufficient to satisfy any income tax liability. It is also important to assess the nature of the business activity to ensure that the business of the for-profit is consistent with the charity's mission.

In the case of general partnerships, a public charity will rarely accept general partner interests as the business of the general partnership constitutes non-charitable activities and subjects the charity's assets to claims of creditors of the partnership.

Charitable Gifts of Interests in Pass-Through Entities

Gifts of interests in pass-through entities pose unique challenges for both the business owner and the public charity. Careful consideration must be given to avoid inadvertent tax consequences and to attain the desired charitable benefit.

- ▶ **General Rule.** The value of the gifted interest in the pass-through entity generally is the fair market value of the donor's share of the entity's assets provided the entity has no liabilities.
- ▶ **Passive Losses.** In the case of a donor who has not at all times materially participated in trade or business activities, if the donor has accumulated unrecognized losses, the losses are added to the carryover basis to the charity.¹⁶ Effectively, the tax benefit of the passive losses will be forfeit to the extent they are allocable to the gift. In the event the interest has associated passive losses, the donor may wish to consider selling the interest which would then allow the donor to recognize the loss and make a charitable gift of the proceeds following the sale.
- ▶ **Hot Assets.** Another important consideration in evaluating a gift of a pass-through interest is the presence of "hot assets" (e.g., unrealized receivables

¹⁴ IRC Sections 512, 513.

¹⁵ IRC Section 512(b).

¹⁶ IRC Section 469(j)(6).

and inventory), in the entity.¹⁷ Gain realized from a transfer of such interests is ordinary income and the charitable deduction must be reduced by the donor's share of any ordinary income that would have been realized if the property had been sold at fair market value on the date contributed.

- ▶ **Bargain Sale.** For gifts of pass-through interests subject to liabilities (where the partner is not relieved of any debt as a result of the transfer of the partnership interest even if the indebtedness is nonrecourse and unsecured), the transaction is bifurcated into a charitable contribution and a deemed sale. The amount of the charitable contribution is equal to the amount by which the fair market value of the donor's share of the partnership assets exceeds the partner's share of the liabilities.¹⁸ The donor will be deemed to have sold the interest to the extent of the donor's allocable share of liabilities transferred to the charity, and the donor's basis will be allocated pro rata between the amount deemed sold and the amount treated as a gift to charity.¹⁹
- ▶ **Indebtedness.** Generally, if the gift is an interest in a pass-through entity that owns assets subject to a mortgage or other similar lien, the amount of the indebtedness secured by such mortgage or lien is considered acquisition indebtedness even though the charity does not assume or agree to pay such indebtedness.²⁰ When there is acquisition indebtedness, a portion of the gross income (including capital gain) generated by the property is unrelated business taxable income.²¹ There is an exception for mortgages placed on property for a period of time before the date of the gift.²²

Charitable Gifts of S Corporation Stock

There are planning issues unique to transfers of S Corporation stock that must be considered in contemplating a gift to charity.

- ▶ **Permissible Shareholders.** While a public charity and a charitable lead trust can accept transfers of S Corporation stock²³, gifts of S Corporation stock to charitable remainder trusts are not permitted.
- ▶ **Ordinary Income Assets.** The charitable deduction for the gift of appreciated stock may be reduced by the amount of ordinary income the shareholder would have recognized to the extent of any gain attributable to certain assets, e.g. appreciated inventory or unrealized receivables. All charitable contributions of

17 IRC Section 751.

18 Rev. Rul. 75-194.

19 IRC Sections 752; 1011(b).

20 IRC Section 514(c)(2)(A).

21 IRC Section 512(b)(4).

22 IRC Section 514(c)(2)(B).

23 IRC Sections 1361(b)(1)(B); 1361(c)(6).

ordinary income property are required to be reduced by the amount of ordinary income that would have resulted had the contributed property been sold at its fair market value as determined at the time of contribution.²⁴

- ▶ **Gain on Sale of Stock.** The charity will realize gain on the sale of S Corporation stock. If the public charity has created a corporate-form or a trust-form supporting organization²⁵, it may acquire, hold, and sell the S corporation stock in such organization. The income tax charitable deduction available to tax-exempt corporations or charitable trusts receiving unrelated business income can effectively reduce the overall rate of income tax, leaving more proceeds available on the disposition of the stock to charity to fulfill the donor's charitable intentions.
- ▶ **Unrelated Business Taxable Income.** All items of income and gain for the period of time the charity owns the stock, as well as the gain on the redemption of the shares, will constitute UBTI as described earlier in this article and is taxable to the charity as shareholder, regardless of any actual distributions made from the corporation to the shareholder.²⁶ The practitioner should anticipate that the charity may seek an assurance from the donor that any distributions from the corporation for the period of time the charity anticipates owning the stock will be adequate to satisfy the potential tax liability.

Charitable Gifts of C Corporation Stock

Shares of stock in a C Corporation are the easiest of the closely held interests to give to charity because the C Corporation is considered a separate taxpayer. The donor is entitled to a full fair market value deduction for a gift of such stock to charity, along with avoidance of the built-in capital gain. Gifts of C Corporation stock do not involve the unrelated business income, phantom income, or donee liability as discussed in this article in the context of other closely held business interests.

Deductible Charitable Contributions to Private Foundations and Charitable Trusts

Closely held business owners have a number of structures from which they can choose to accomplish gifts to charity. While this article is intended to address gifts of business interests directly to public charities, business owners may be able to accomplish their charitable and tax objectives through other vehicles.

24 IRC Section 170(e)(1).

25 IRC Section 509(a)(3).

26 IRC Section 512.

For business owners contemplating the organization of a tax-exempt family foundation to meet retirement and other estate planning goals, donors can make contributions that qualify for charitable deductions to such private foundations. Administrative complexity and rules aside, practitioners should be aware of limitations on gifts of closely held business interests to private foundations.

- ▶ A gift of a closely held interest to a private foundation is deductible up to 20% of adjusted gross income (as opposed to 30% for a donation to a public charity).²⁷ Excess deductions can be carried forward for five years.²⁸
- ▶ Transferring a business interest to a family foundation may trigger the prohibition on engaging in self-dealing transactions, e.g. transactions between the foundation and a donor, members of the donor's family or other "disqualified persons" which are generally prohibited under the IRS rules governing private foundations.²⁹
- ▶ The excess business holdings rule may also limit the ability of the foundation to own closely held interests. If the individual is able to make the gift despite the foregoing, the deduction for a gift of the closely held interests to a private foundation is limited to the lesser of fair market value of the property or cost basis.³⁰

A donor may wish to consider a gift of a business interest to a charitable remainder trust or a charitable lead trust. For federal income tax purposes a donor can deduct a charitable gift of an income or "lead" interest to a charity in a charitable lead trust created by the donor, with divided beneficial ownership, in other words, payments are made to the charity for a specified term with the remainder payable to non-charitable beneficiaries.³¹ The lead interest is the charity's right to receive annuity or unitrust payments for a certain term. The charitable lead trust is not exempt from federal income tax, so the practitioner must draft accordingly as the manner in which trust income is taxed depends on whether the trust is a grantor or a non-grantor trust.

Alternatively, a donor may wish to provide a remainder interest to charity. A charitable contribution deduction is immediately allowed for the present value of the remainder interest transferred to charity in trust (in some cases limited to cost basis).³² The trust must provide for the payment of a specified distribution to one or more beneficiary (at least one must not be a charity) for a term and with a remainder interest to be paid to or held for the benefit of a charity. A charitable remainder trust is a tax-exempt entity.³³

27 IRC Section 170(b)(1)(D).

28 Id.

29 IRC Section 4941.

30 IRC Section 170(e)(1) and Regs. Sec. 1.170A-1(c)(1).

31 IRC Sections 170(f)(2)(B).

32 IRC Sections 170(f)(2)(A).

33 IRC Section 664(c).

Thus, the grantor does not incur capital gain on the transfer of appreciated property to the trust, and the trust pays tax on the UBTI.³⁴

Conclusion

Gifts of closely held business interests to charity in a tax-efficient manner requires planning and analysis as variations in the structure of the gift may mean the difference between a fair market value tax deduction, a deduction only for the donor's cost basis, or no deduction at all. A well planned gift of a closely held business interest may accomplish a significant tax benefit and provide an opportunity for an individual to support a charity and provide vital support for the community to which the individual's business and family are connected.

With a view toward philanthropy and the appropriate structure, a gift of a business interest to a public charity ensures a business owner will receive the most favorable tax treatment while accomplishing philanthropic goals.

The Community Foundation is experienced in accepting gifts of closely held business interests, and we can work with you and your clients to make the gifting process straightforward and efficient, consistent with your clients' business and estate planning goals.

We know southeast Michigan and nonprofits in our region. We can work with you and your clients to advise you about grantmaking to organizations locally and nationally..

**Call 313-961-6675 or visit
CFSEM.org/Advisors
for more information.**

³⁴ Id.

Community Foundation

FOR SOUTHEAST MICHIGAN