**GREATER BOCA ESTATE PLANNING COUNCIL**

**Charitable Giving For Family Business Families**

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Charitable gifts involving some kind of closely held business entity are becoming an increasingly important element of an overall estate plan. They can be an effective tool to maximize the benefits of valuation discounts, reduce income and estate taxes, and generally promote your client's estate planning and philanthropic goals. But it is important to understand the unique tax and other implications of the gift from the perspectives of the donor, the donee, and the closely-held business entity. It is equally important to plan for the ultimate disposition of the business interest—will the charity hold the interest long-term, or should the plan include an appropriate “exit strategy”?

The purpose of this outline is to provide something of a primer on the basic issues, and some “food for thought” on some interesting planning ideas. For the most part, discussions of charitable remainder trusts, lead trusts, and gift annuities have been limited to the areas unique and pertinent to business planning.

1. CHARITABLE DEDUCTION OVERVIEW
   1. Income Tax
      1. Contributions to Public Charities
         1. Gifts of Cash or Unappreciated Property. Gifts of cash or unappreciated property to public charities are deductible at fair market value up to 50 percent of the donor’s contribution base (essentially adjusted gross income). IRC § 170(b)(1)(A). Gifts “for the use of” public charities are deductible up to 30 percent of the donor’s contribution base. IRC § 170(b)(1)(A) and (B).
         2. Gifts of Appreciated Property. Gifts of appreciated property to public charities are deductible up to 30 percent of the donor’s contribution base. IRC § 170(b)(1)(C).
            1. Long-term capital gain property (any capital asset the sale of which at its fair market value at the time of contribution would result in long-term capital gain, i.e., property held more than one year (IRC § 170(b)(1)(C)(iv); IRC § 1221)) may be deducted at fair market value. A donor may elect to increase the limit on the deduction for long-term capital gain to 50 percent of the contribution base, but must then reduce the value of the gift by the long-term gain. IRC § 170(b)(1)(C)(iii).
            2. The deduction for short-term capital gain property (any property the sale of which would produce a gain that is not long-term capital gain) is reduced by the amount of the non-long-term gain. IRC § 170(e). Generally, this means that the deduction for short-term capital gain property is limited to basis.
      2. Contributions to Private Foundations
         1. Gifts of cash or unappreciated property. Gifts of cash or unappreciated property to private foundations other than private operating foundations are deductible at fair market value up to 30 percent of the donor’s contribution base. IRC § 170(b)(1)(A) and (B).
         2. Gifts of appreciated property. Gifts of appreciated property to private foundations other than operating foundations are deductible up to 20 percent of the donor’s contribution base. IRC § 170(b)(1)(D).
            1. Contributions of “qualified appreciated stock” (stock for which market quotations are readily available on an established securities market) can be deducted at fair market value. IRC § 170(e)(5).
            2. The deduction for all other types of appreciated property to private non-operating foundations is limited to the donor’s basis in the property. IRC § 170(e)(1)(B)(ii).
      3. Five-Year Carryforward. Contributions which exceed the contribution base may be carried forward for up to five years. For contributions to which the 50 percent/30 percent limitation applies, see IRC §§ 170(d)(1)(A) and 170(b)(1)(C)(ii). For contributions to which the 30 percent/20 percent limitation applies, see IRC §§ 170(b)(1)(B) and 170(b)(1)(D)(ii).
   2. Estate Tax. IRC § 2055 provides an unlimited deduction from a decedent’s gross estate for bequests, legacies, devises and transfers to qualifying recipients for public, charitable, religious, and other similar purposes.
      1. The charitable deduction is reduced by the amount of any estate, succession, legacy or inheritance taxes that are, either by the terms of the will or local law, assessed against an otherwise deductible transfer. IRC §  2055(c).
      2. The amount of the deduction may not exceed the value of the transferred property that is required to be included in the gross estate. IRC § 2055(d).
      3. No deduction is allowed for a transfer to or for the use of an organization or trust described in IRC §§ 508(d) or 4948(c)(4), subject to the conditions specified in those sections. IRC § 2055(e)(1).
      4. Where an interest in property is split between charitable and noncharitable recipients, special rules apply. IRC § 2055(e)(2).
   3. Gift Tax. IRC § 2522 provides an unlimited gift tax deduction for lifetime transfers to qualifying recipients for public, charitable, religious and other similar purposes. In effect, the deduction operates as an exclusion. With minor exceptions, the definition of eligible recipients and qualifying transfers are identical to those applicable for federal estate tax purposes.
   4. GST Tax. IRC § 2642(a) provides that in determining the inclusion ratio for purposes of the generation-skipping transfer tax, the denominator of the fraction is reduced by “any charitable deduction allowed under section 2055 or 2522 with respect to such property.” In essence, this eliminates charitable gifts from the equation for calculating the tax.
2. CLOSELY-HELD BUSINESS INTERESTS GENERALLY.
   1. Valuation. Noncash gifts are generally valued at “fair market value,” raising familiar problems of determination of value. Aggressive or fraudulent valuations of charitable contributions have been a problem since enactment of the first charitable deduction in 1917. Traditionally most of the reported decisions involved charitable gifts of artwork. As noted by the judge in a 1984 Tax Court overvaluation case (not involving a charitable contribution), “after examining some of the paintings, we feel obliged to note that we refer to them as artwork merely for convenience.” J.S.M. Enterprises v. Commissioner, 48 T.C.M. 138 (1984). Recent audit data, however, confirms that the valuation of charitable gifts of business interests is the subject of increasing IRS scrutiny.
      1. Burden of Proof. As in most valuation disputes, the donor has the burden of proof in a charitable deduction case. Welch v. Halvering, 290 U.S. 111 (1933); Lamphere, 70 T.C. 391 (1978). See also Holtzman, 40 T.C.M. 350 (1980).
      2. Valuation Penalties.
         1. Substantial Valuation Misstatement. The “accuracy-related” penalties of IRC § 6662 apply to charitable contributions. There is a 20 percent penalty on any underpayment of tax (in excess of $5,000) resulting from a “substantial valuation misstatement” – if the value or tax basis of any property claimed on an income tax return is 150 percent or more of the correct amount (or stated another way, if the correct value is two-thirds or less of the claimed value). IRC § 6662(e)(1)(A). (Before enactment of the Pension Protection Act of 2006 (“PPA 2006”), generally effective for returns filed after August 17, 2006, the threshold was 200 percent (i.e., if the correct value is 50 percent or less of the claimed value).)
         2. Gross Valuation Misstatement. The penalty increases to 40 percent on any underpayment of tax (in excess of $5,000) resulting from a “gross valuation misstatement” – if the reported value or basis is 200 percent or more of the correct amount (i.e., if the correct value is 50 percent or less of the claimed value). IRC § 6662(h). (Before PPA 2006, the threshold was 400 percent (i.e., if the correct value is 25 percent or less of the claimed value).)
         3. Other Taxpayer Penalties. Fraud penalties of 75 percent can be imposed on any underpayment of tax attributable to fraud. IRC § 6663. Criminal penalties are also possible. IRC §§ 7206 and 7207.
         4. Reasonable Cause Exception. Most underpayment penalties provide a general exception if the taxpayer can show “reasonable cause” and “good faith.” IRC § 6664(c)(1). The exception is completely inapplicable, however, to “gross” overvaluations of “charitable deduction property” (property for which a charitable deduction is claimed), and to “substantial” overvaluations unless the donor can demonstrate that (1) the claimed value of the property was based on a “qualified appraisal made by a qualified appraiser” and (2) the donor made a “good faith investigation of the value of the contributed property.” IRC § 6664(c)(3).
         5. Appraiser Penalties. There are also penalties for appraisers who value property at a value that is 150 percent or more than the correct value (i.e., subject to either of the valuation misstatement penalties) if the appraiser knows, or reasonably should have known, that the appraisal would be used in connection with a tax return. IRC § 6695A(a). The amount of the penalty is the greater of 10 percent of the underpayment or $1,000, but with a maximum of 125 percent of the appraisal fee received by the appraiser. IRC § 6695A(b). There is an exception if the appraiser can establish to the satisfaction of the IRS that the appraised value was “more likely than not the proper value” (whatever that means). IRC § 6695(c).
         6. These valuation issues could be affected by proposed regulations issued in August 2016 described below.
   2. Substantiation.
      1. Generally. On several occasions since 1982, Congress has imposed increasingly stringent rules for the verification and reporting of charitable contributions. In most cases, the penalty for noncompliance is the complete disallowance of an income tax charitable deduction. (There are no comparable requirements for the gift and estate tax charitable deductions, but the donor must submit such data as may be requested by the IRS. Treas. Reg. §§ 20.2055-1(c) and 25.2522(a)-1(c).) Separate rules exist for cash contributions, contributions of property with a value of less than $500, contributions of property with a value of less than $5,000, contributions of property with a value in excess of $5,000, and contributions of artwork with a value in excess of $20,000.
      2. Receipt Requirement. Since 1993, no charitable deduction is allowable for any contribution of cash or other property with a value of $250 or more unless the donor obtains a “contemporaneous written acknowledgement” from the donee organization, regardless of how reliable the donor's records otherwise may be. IRC § 170(f)(8)(A). The required acknowledgment must include a variety of information relating to the gift, and it must be received by the donor before the earlier of (1) the date of filing the donor's tax return claiming the deduction or (2) the due date (including extensions) for filing the return. IRC § 170(f)(8)(B), (C). This is rarely a problem in the case of gifts to public charities, which generally issue acceptable receipts as a matter of course, but the Service does not take kindly to receipts that do not contain all essential information required by the statute (see, e.g., Durden v. Commissioner, T.C. Memo. 2012-140 (2012); DiDonato v. Commissioner, T.C. Memo. 2011-153 (2011)).
         1. This rule applies to gifts to private foundations, even to trust-form private foundations of which the donor is the sole trustee. Compliance with the rule in this case would thus literally require the donor as trustee to give a receipt to him or herself.
         2. In the case of charitable gifts by S Corporations or partnerships, the entity is treated as the taxpayer for substantiation purposes, so the shareholder or partner is not required to obtain any additional substantiation for his or her share of the contribution. Treas. Reg. § 1.170A-13(f)(15).
         3. The receipt requirement does not apply to gifts to charitable remainder trusts, but it does apply to transfers to pooled income funds. Treas. Reg. § 1.170A-13(f)(13).
      3. Appraisal Requirements. Section 155 of the Tax Reform Act of 1984 imposed new procedures for verification and substantiation of contributions of property (other than cash or most publicly traded securities) with a claimed value of more than $5,000. Section 155 was not made a part of the Internal Revenue Code, but rather merely directed the Secretary of the Treasury to prescribe regulations. The basic requirement is now codified in IRC §§ 170(f)(11)(C) and (D). Under these substantiation rules, the donor must obtain a “qualified appraisal” of the contributed property from a “qualified appraiser,” and attach an “appraisal summary” (IRS Form 8283) to the income tax return claiming a charitable deduction. Treas. Reg. § 1.170A-13(c)(2).
         1. The $5,000 threshold for property gifts subject to appraisal is determined on an annual basis, and the donor must take into account all gifts of the same or “similar” items and property donated during the year, whether or not donated to the same organization. Treas. Reg. § 1.170A-13(c)(1)(i). Gifts of cash or publicly traded securities are not subject to the appraisal rules, and a limited exception exists for gifts of non-publicly traded stock if the deduction involved is less than $10,000. Treas. Reg. § 1.170A-13(c)(2)(ii).
         2. The appraisal rules apply to gifts by individuals, partnerships, and most corporations. Treas. Reg. § 1.170A-13(c)(1)(i).
         3. The appraisal must be made no earlier than 60 days before the date of contribution and no later than the due date (including extensions) of the return on which the charitable deduction is claimed. Treas. Reg. § 1.170A-13(c)(3)(i).
         4. The appraisal must be received by the donor on or before the due date (including extensions) of the return on which the deduction is first claimed or reported, or in the case of a deduction first claimed on an amended return, the date the return is filed. Treas. Reg. § 1.170A-13(c)(3)(iv)(B).
         5. The regulations require that a “qualified appraisal” must contain a variety of detailed information (including items not generally included in appraisals), as follows:
         * A description of the property in sufficient detail for a person who is not generally familiar with the type of property to ascertain that the property that was appraised is the property that was (or will be) contributed;
         * In the case of tangible property, the condition of the property;
         * The date (or expected date) of contribution;
         * The terms of any agreement that restricts the donee’s right to use or dispose of the property, reserves to or confers upon any person the right to the income from or possession of the property (such as charitable remainder trusts, pooled income funds, and charitable gift annuities), or earmarks the property for a particular use;
         * The name, address, and taxpayer identification number of the appraiser and the appraiser’s employer (if any);
         * The qualifications of the qualified appraiser who signs the appraisal, including the appraiser's background, experience, education, and membership, if any, in professional appraisal associations;
         * A statement that the appraisal was prepared for income tax purposes;
         * The date (or dates) on which the property was appraised;
         * The appraised fair market value of the property on the date (or expected date) of contribution;
         * The method of valuation used to determine the fair market value; and
         * The basis for the valuation, such as specific comparable sales transactions or statistical sampling, including a justification for using sampling and an explanation of the sampling procedure employed.
         1. Proposed regulations issued in 2008 would add even more requirements. See Prop. Reg. §§ 1.170A-15, 1.170A-16, and 1.170A-17.

g. If the claimed value of the contributed property exceeds $500,000, a copy of the qualified appraisal must be attached to the donor's return. IRC § 170(f)(11)(C).

* + 1. Substantial Compliance. The penalty for noncompliance with the qualified appraisal rules is the complete disallowance of a charitable deduction. Some taxpayers have successfully argued substantial compliance (see, e.g., Consol. Investors Grp. V. Commissioner, T.C. Memo. 2009-290 (2009); Bond v. Commissioner, 100 T.C. 32 (1993)), but most of the reported decisions have required strict compliance. See, e.g., Scheidelman v. Commissioner, T.C. Memo. 2010-151 (2010); Henry R. Lord v. Commissioner, T.C. Memo. 2010-96 (2010); Friedman v. Commissioner, T.C. Memo. 2010-45 (2010); Hewitt v. Commissioner, 109 T.C. 258 (1997), aff'd 166 F.3d 332 (4th Cir. 1998); D'Arcangelo v. Commissioner, T.C. Memo. 1994-572 (1994). In one recent case that made national headlines, a taxpayer donated real property worth more than $18.5 million but failed to meet the technical qualified appraisal requirements. The Tax Court denied the claimed charitable deduction entirely. Mohamed v. Commissioner, T.C. Memo. 2012-152 (2012). Furthermore, taxpayers who fail to strictly comply with the substantiation rules have been assessed negligence penalties (see, e.g., Olson v. Commissioner, T.C. Memo. 2004-197 (2004)), accuracy-related penalties (see, e.g., Friedman v. Commissioner, T.C. Memo. 2010-45 (2010)), and even fraud penalties (Manning v. Commissioner, T.C. Memo. 1993-127 (1993) (taxpayer claimed nonexistent charitable deductions)).
    2. Donee Reporting. The qualified appraisal rules also include a requirement designed to uncover subsequent dispositions by the donee organization at a market price lower than appraised value. Under this rule, if the contributed property is sold, exchanged, consumed, or otherwise disposed of by the donee within two years after the date of contribution, the donee must file an information return (IRS Form 8282) disclosing the facts of the transaction. IRC § 6050L.
  1. Private Foundation Rules.
     1. Generally. Private foundations (within the meaning of IRC §509) and some split-interest trusts (within the meaning of IRC § 4947) are subject to the so-called “private foundation rules” of IRC §§ 4941 to 4945. These rules can impose “excise taxes” as high as 200 percent of the amount involved in the prohibited transaction, so as a practical matter, they are more in the nature of absolute prohibitions than mere taxes. Briefly stated, IRC §§ 4941 to 4945 impose punitive taxes on foundations, foundation managers, and “disqualified persons” involved in the following:
        + Acts of “self-dealing” (IRC § 4941) (see discussion below);
        + Failure to make qualifying grants of at least a designated amount each year, generally equal to 5 percent of the private foundation's assets (IRC § 4942);
        + “Excess business holdings” (IRC § 4943) (see discussion below);
        + High risk or “jeopardy” investments (IRC § 4944); and
        + “Taxable expenditures,” including grants for impermissible purposes, certain grants to individuals, certain grants to foreign organizations, and certain grants to other private foundations (IRC § 4945).

In the case of charitable gifts of closely-held business interests to private foundations, the restrictions against self-dealing and excess business holdings in particular must be carefully scrutinized to avoid excise tax, particularly if the charitable organization intends to hold the business interest long-term, or if any “exit strategies” involve a sale or other transfer to a disqualified person.

* + 1. Application to Charitable Remainder Trusts. The restriction against self-dealing applies to charitable remainder trusts. IRC § 4947(a)(2). The restrictions against excess business holdings and jeopardy investments apply only if the designated income beneficiaries include charitable organizations. IRC § 4947(b)(3). See also PLR 9210005.
    2. Application to Charitable Lead Trusts. The restriction against self-dealing applies to charitable lead trusts. IRC § 4947(a)(2). The restrictions against excess business holdings and jeopardy investments apply only if the present value of the charitable income interest exceeds 60 percent of the aggregate fair market value of trust assets on the date of creation. IRC § 4947(b)(3).
  1. Self-Dealing.
     1. General Rule. The self-dealing rules effectively prohibit almost any business or other transaction between the foundation and a donor, members of the donor's family, or other “disqualified persons” within the meaning of IRC § 4946, generally including sales, exchanges, leases, loans, payment of compensation, or the furnishing of goods or services. See IRC § 4941. The prohibition is absolute and generally without regard to any consideration paid, and presently the Internal Revenue Service has no equitable authority to excuse harmless violations.

2. Probate Exception. Many transactions that would be impermissible under the self-dealing rules may be allowed under the so-called “probate exception.” Under that exception, a transaction relating to a foundation's interest in property held by an estate (or revocable trust becoming irrevocable upon a grantor's death) is permissible if:

* The personal representative or trustee either:
  + Has a power of sale with respect to the property,
  + Has the power to reallocate the property to another beneficiary, or
  + Is required to sell the property under the terms of any option subject to which the property was acquired by the estate or trust;
* Such transaction is approved by the court having jurisdiction over the estate or trust (or the foundation);
* Such transaction occurs before the estate is considered terminated for federal income tax purposes, under the rules of Treas. Reg. § 1.641(b)-3 (or in the case of a revocable trust, before it is considered subject to IRC §4947);
* The estate or trust receives an amount that equals or exceeds the fair market value of the foundation's interest or expectancy in such property at the time of the transaction, taking into account the terms of any option subject to which the property was acquired by the estate (or trust); and
* The transaction either:
  + Results in the foundation receiving an interest or expectancy at least as liquid as the one it gave up,
  + Results in the foundation receiving an asset related to the active carrying out of its exempt purposes, or
  + Is required under the terms of any option which is binding on the estate (or trust).

Treas. Reg. § 53.4941(d)-1(b)(3).

3. Option Alternative. The use of an option when implementing the probate exception can provide significant flexibility with respect to transactions contemplated between the private foundation and the disqualified person’s estate or revocable trust. Under the “option alternative” to the probate exception, the terms of the option agreement would govern the terms of the proposed transaction, providing significant advantages:

* + - 1. The executor/trustee would not be required to exercise her discretion to sell or reallocate the property owned by the estate/trust, but rather would be required to effectuate the transaction pursuant to the terms of the option agreement. As a result, it would be more difficult for a party to challenge the executor/trustee’s actions from a fiduciary standpoint.
      2. Similarly, because the proposed transaction would have been specifically contemplated and indeed approved by the decedent, approval by the probate court should be easier to obtain.
      3. Consideration will be dictated by the terms of the option agreement, avoiding the need for “fair market value” to be a condition to the transaction, though obviously consideration under the option agreement could (and perhaps should) be tied to fair market value to avoid a mismatch between the value of the asset for estate tax purposes and the sales price. In the case of supporting organizations, the term “excess benefit transaction similarly includes any “grant, loan, compensation, or similar payment” from the organization to substantial contributors, members of the family of a substantial contributor, or a very broad variety of other disqualified persons. IRC § 4958(c)(3).
      4. Likewise, there will not be a need for the transaction to satisfy the “liquidity” or “related use” components of the probate exception because the terms of the option agreement will govern. This eliminates another potentially tricky factual determination from the process.
      5. The option alternative does not specify any terms or conditions that the option agreement is required to satisfy. Consideration paid under the option agreement could be in the form of a promissory note, perhaps bearing interest at the AFR. Based upon anecdotal information, the IRS in recent years has been reluctant to issue private letter rulings in situations involving the option alternative when a note is used. However, the use of a promissory note under the option alternative to the probate exception is specifically contemplated in Treasury Regulations:

“Similarly, except in the case of the receipt and holding of a note pursuant to a transaction described in § 53.4941(d)-1(b)(3) [which describes the probate exception], an act of self-dealing occurs where a note, the obligor of which is a disqualified person, is transferred by a third party to a private foundation which becomes the creditor under the note.” Treas. Reg. § 53.4941(d)-2(c)(1).

4. Corporate Adjustment Exception. The “corporate adjustment” exception similarly permits certain transactions that would otherwise be impermissible. Under that exception, stock redemptions (and other corporate transactions) between a foundation and a corporation that is a disqualified person (as defined in IRC § 4946(c)) are permissible if:

* The corporation offers to all the shareholders the opportunity to redeem “all the securities of the same class \* \* \* subject to the same terms and conditions”;
* The redemption offer constitutes a “bona fide offer” to redeem from all the shareholders; and
* The redemption price is “no less than fair market value.”

IRC § 4941(d)(2)(F); Treas. Reg. § 53.4941(d)-3(d)(1).

The Service has been surprisingly lenient in recognizing redemptions in which it is anticipated that the charitable donee will be the only shareholder accepting the corporation's redemption offer. See, e.g., PLR 200720021, PLR 9338046, PLR 9108030, and PLR 9015055. The terms of the redemption must be identical. For example, if the foundation receives debentures and the other shareholders receive cash, the exception likely will not apply.

Moreover, while the corporate adjustment exception applies specifically to transactions between a private foundation and a corporation, the IRS has privately ruled in the past that the exception can be applied to transactions between a private foundation and a partnership. For example, in PLR 200734023, the IRS ruled that the exception applied to a private foundation’s redemption of limited partnership interests in a partnership that was a disqualified person. However, we have not identified any ruling applying the corporate adjustment exception to transactions between an LLC and a private foundation.

5. Similar Rules for Donor Advised Funds and Supporting Organizations. The self-dealing rules apply only to private foundations (within the meaning of IRC § 509) and some split-interest trusts (within the meaning of IRC § 4947). PPA 2006 added certain transactions involving donor advised funds or supporting organizations as automatic “excess benefit transactions” under IRC § 4958, subject to excise taxes as high as 200 percent of the excess benefit involved. These rules are in many respects more restrictive than the private foundation self-dealing rules, and the class of disqualified persons much broader.

* + - 1. In the case of donor advised funds, the term “excess benefit transaction” includes any “grant, loan, compensation, or similar payment” from the fund to donors, fund advisors, or a very broad variety of other disqualified persons. IRC § 4958(c)(2). PPA 2006 also added excise taxes on a variety of noncharitable and other “taxable distributions,” and on distributions resulting in more than an “incidental benefit” conferred upon a donor, fund advisor, or other disqualified person. IRC §§ 4966 and 4967.
      2. In the case of supporting organizations, the term “excess benefit transaction similarly includes any “grant, loan, compensation, or similar payment” from the organization to substantial contributors, members of the family of a substantial contributor, or a very broad variety of other disqualified persons. IRC § 4958(c)(3).
  1. Excess Business Holdings.
     1. General Rule. The purpose of the excess business holdings rule, like the purpose of the unrelated business income tax, is to prevent tax-exempt organizations from competing unfairly with taxable businesses. Under IRC § 4943, a private foundation is permitted to hold only very limited interests in an unrelated business enterprise. With respect to an incorporated business enterprise, the general rule is that a private foundation and all disqualified persons together may not own more than 20 percent of the voting stock, but this limit is raised to 35 percent if a third person has effective control of the business. IRC § 4943(c). Nonvoting stock is permitted, but only if all disqualified persons together do not own more than 20 percent of the voting stock. IRC § 4943(c)(2). Similar rules exist for partnerships, joint ventures, and limited liability companies. No holdings are permissible in the case of a business enterprise operated in proprietorship form. IRC § 4943(c)(3).
        1. The excess business holdings rules apply to ownership in a “business enterprise.” That term does not include a trade or business which is not an “unrelated” trade or business (as defined in IRC § 513). IRC § 4943(d)(3)(A).
        2. The term “business enterprise” also excludes any trade or business at least 95 percent of the gross income of which is derived from “passive sources.” IRC § 4943(d)(3)(B).
        3. These exceptions are consistent with Congress's intent to prevent tax-exempt organizations from competing unfairly with taxable businesses, but to permit tax-exempt organizations to engage in passive investment activities.
     2. Application to Donor Advised Funds and Supporting Organizations. Since enactment of PPA 2006, the restrictions on excess business holdings apply to “donor advised funds” (within the meaning of IRC § 4966(d)(2)) and to “supporting organizations” (within the meaning of IRC § 509(a)(3)). Until enactment of PPA 2006, the restrictions on excess business holdings applied only to private foundations.
        1. The excess business holdings rule applies to donor advised funds as if they were private foundations, but with extensive phased-in divestiture rules for existing holdings. IRC § 4943(e). In addition, for purposes of these new rules the term “disqualified person” is defined much more expansively than the IRC § 4946 definition applicable to private foundations, and it includes organizations controlled by the fund advisors or members of their family and organizations which receive substantially all their contributions from the fund advisors or related parties. IRC § 4943(e)(2).
        2. The excess business holdings rule applies to some, but not all, supporting organizations. The rules apply to (i) all “Type III” supporting organizations other than “functionally integrated Type III supporting organizations” (defined in IRC § 4943(f)(5) to mean a Type III supporting organization which is not required to make payments to supported organizations due to the activities of the organization related to performing the functions of, or carrying out the purposes of, such supporting organization) and (ii) “Type I” supporting organizations if the supported organization is directly or indirectly controlled by the supporting organization’s donors. IRC § 4943(f)(3). As with donor advised funds, the term “disqualified person” is defined much more expansively than the IRC § 4946 definition applicable to private foundations, and it includes organizations controlled by the same persons who control the supporting organization and organizations which receive substantially all their contributions from the supporting organization’s substantial contributors or related parties. IRC § 4943(f)(4).
  2. Charitable Gifts to a Single-Member LLC Owned by Charity.
     1. Background. Charitable organizations have attempted for many years to develop a way to accept gifts of real property or other problematic assets through some kind of limited liability entity, so that any environmental or other property-related liabilities would be contained in the entity and would not endanger the organization’s other assets. A single-member LLC would be an ideal vehicle by which to accomplish this goal. Single-member LLCs are treated as “disregarded entities” for tax purposes, so no separate tax reporting is required, and generally the owner of the LLC is not responsible for any liabilities attributable to property owned by the LLC. The problem is that the Internal Revenue Service has until very recently refused to rule whether, even though a single-member LLC is a disregarded entity for tax purposes, gifts by a donor to a single-member LLC owned by a charitable organization would qualify for the income tax charitable deduction.

2. Notice 2012-52. On August 2, 2012, the IRS issued Notice 2012-52, confirming that it will treat a contribution to a disregarded single-member LLC, wholly owned and controlled by a U.S. charitable organization, as a charitable contribution to the organization. The Notice also confirms that the donor will be entitled to the same charitable deductions allowable under IRC § 170(a) for a gift directly to the organization owning the LLC, and that the organization owning the LLC will be treated as the donee for purposes of the substantiation and disclosure rules of IRC §§ 170(f) and 6115. Finally, the Notice “encourages” charitable organizations accepting gifts of this nature to disclose to the donor, in the gift acknowledgement, that the single-member LLC is wholly owned by the charitable organization and is treated as a disregarded entity. Unfortunately, the ruling does not refer to IRC §§ 2055 or 2522, but all but the most conservative practitioners appear to ignore the potential estate and gift tax issue

* 1. Use of Section 501(c)(4) Organizations to Facilitate Business Interest Ownership.
     1. Background. Under the Protecting Americans from Tax Hikes Act of 2015, IRC § 2501(a) was amended to specifically exclude from federal gift tax “transfers of money or other property to an organization described in paragraph (4), (5), or (6) of section 501(c) and exempt from tax under section 501(a), for the use of such organization.” This exclusion from federal gift tax is applicable to lifetime gifts to section 501(c)(4), (5), and (6) organizations, but does not apply to transfers at death. Accordingly testamentary transfers to section 501(c)(4), (5), and (6) organizations still would be taxable for estate tax purposes. Moreover, lifetime transfers to these organizations also could be subject to IRC § 2036.
     2. Section 501(c)(4) Organizations Generally. Section 501(c)(4) Organizations include:
        1. Section 501(c)(4) organizations include “civic leagues” and “social welfare organizations,” which must be nonprofit and organized for the promotion of the common good and general welfare of the community as a whole, and “local associations of employees,” in which membership is limited to employees of a particular person or particular person in a designated locality, and the earnings of which must be used for charitable, educational or recreational activities
        2. Specific examples of section 501(c)(4) organizations include homeowners associations, veterans groups, community centers and community programs, volunteer fire departments, parks associations, public recreational facilities, and service organizations.
        3. No private inurement is permitted for a section 501(c)(4) organization.
     3. Section 501(c)(4) Organization are NOT Disqualified Person. A section 501(c)(4) organization does not appear to fit within the definition of “disqualified person,” because it is:
* Not a substantial contributor or foundation manager;
* Not an individual
* Not a “35 percent” corporation, partnership, trust or estate; and
* Not a private foundation.

The authors have not identified any cases or rulings establishing that a section 501(c)(4) organization would be a disqualified person. This may create a useful opportunity to use section 501(c)(4) organizations to avoid excess business holdings and self-dealing issues that could arise from transfers of closely-held business interests to a private foundation.

* + 1. Avoiding Excess Business Holdings. IRC § 4943 would preclude a private foundation from long-term ownership of more than 20 percent of the voting stock of a corporation or other business enterprise in combination with all disqualified persons. However, if a section 501(c)(4) organization is not a disqualified person, it could own a “business enterprise” with one or more private foundations in a manner that would avoid violating the prohibition against excess business holdings under IRC § 4943. If an owner transferred interests in a closely-owned business to a private foundation in conjunction with a transfer to a section 501(c)(4) organization, it may be possible to avoid excess business holdings. For example:
       1. Donor could recapitalize her closely-held business enterprise from 1 million shares of common stock to 100,000 shares of voting stock and 900,000 shares of nonvoting stock.
       2. Donor then could contribute 80,000 shares of voting stock to a new section 501(c)(4) organization that Donor’s family controls, without incurring gift tax.
       3. At death, Donor could contribute 20 percent of voting stock and all nonvoting stock to a private foundation, and the section 501(c)(4) organization would own 80 percent of the voting stock.
    2. Avoiding Self-Dealing. If a section 501(c)(4) organization is not a disqualified person (even if it is controlled by one or more disqualified persons) it would be permissible for a private foundation and the section 501(c)(4) organization to enter into transactions that ordinarily would be treated as self-dealing. For example a section 501(c)(4) organization could:
       1. Purchase or borrow assets from a related private foundation.
       2. Lease real estate to a related private foundation.
       3. Co-own and co-invest with a related private foundation.

1. CHARITABLE GIFTS OF C CORPORATION STOCK
   1. Generally.

Unlike charitable gifts of partnership or LLC interests or S corporation stock, gifts of C corporation stock generally are straightforward and do not involve the phantom income, unrelated business income, and donee liability problems discussed in this outline.

* 1. Charitable Bailout.

A charitable gift of C Corporation stock followed by redemption by the corporation can be a great way to accommodate the donor's charitable objectives, ultimately fund the gift with cash, and permit the tax-free distribution of excess cash accumulated in the corporation. This plan is sometimes referred to as a “charitable bailout” because both the charitable gift and the subsequent redemption would be completely income tax free, and the corporation would be able to “bail out” its accumulated cash. In the case of gifts to a private foundation or charitable remainder trust, the redemption must comply with the “corporate adjustment” exception to the self-dealing rules (see discussion above).

* 1. Prearranged Redemptions and Assignment of Income Issues.

1. The Problem. Charitable gifts are often prompted by upcoming taxable events. For example, an owner in the process of selling a business may wish, as part of that transaction, to make a gift of part of the stock to charity to (a) obtain a charitable income tax deduction to offset income generated by the sale and (b) avoid the capital gain income that would have been realized and taxed to the owner if he or she still held the stock at the time of the sale. The latter objective frequently triggers issues in connection with timing. Similar issues also arise frequently with gifts of real estate or other assets. The question is: at what point in the sale process is it too late for the donor to avoid the realization of capital gain income by giving the asset to charity?

2. The Assignment of Income Doctrine. Under the anticipatory assignment of income doctrine, a taxpayer who earns or otherwise creates a right to receive income will be taxed on any gain realized from that right if, based on the realities and substance of events, the receipt of income is practically certain to occur, even if the taxpayer transfers the right before receiving the income (see Ferguson v. Commissioner, 174 F.3d 997 (9th Cir. 1999); Lucas v. Earl, 281 U.S. 111 (1930)). The related step transaction doctrine similarly prevents a taxpayer from escaping taxation by collapsing a series of substantially linked steps into a single overall transaction (see Penrod v. Commissioner, 88 T.C. 1415, 1428 (1987)).

3. Bright Line Test. In Palmer v. Commissioner (62 T.C. 684 (1974), aff'd on other grounds, 523 F.2d 1308 (8th Cir. 1975), acq, 1978-1 C.B. 2), the Tax Court held that a taxpayer's gift of stock in a closely-held corporation to a private foundation, followed by a redemption, would not be characterized as a sale or redemption between the taxpayer and the corporation followed by a gift of the redemption proceeds to the foundation, because the foundation was not legally obligated to redeem the stock at the time it received the shares. In Revenue Ruling 78-197 (1978-1 C.B. 83), the Service announced that it would treat the proceeds of a stock redemption under facts similar to those in the Palmer case 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. The “bright line” test of Palmer and Revenue Ruling 78-197 has become somewhat muddled, and the bright-line is not haze free.

4. Fuzzing the Line.

* + - 1. In Blake v. Commissioner, 42 T.C.M. 1336 (1981), aff’d, 697 F.2d 473 (2d. Cir. 1982), the donor contributed stock to a charity with the understanding that the charity would permit the corporation to redeem the stock and the charity would then use the proceeds to buy the donor’s yacht at an inflated price. The yacht was sold shortly thereafter by the charity for less than 50 percent of the price it had paid the donor. The Second Circuit Court of Appeals found the “understanding” enough to re-characterize the transaction as a sale of stock by the donor, followed by a contribution of the yacht to charity. Note that, unlike in other situations, there was a quid pro quo required by the donor in order for the donor to make the stock gift.
      2. The next significant case was Ferguson v. Commissioner, 108 T.C. 244, (1997), aff’d, 174 F.3d 997 (9th Cir. 1999), which involved a gift of stock followed by a redemption pursuant to the terms of a merger agreement. The donors were directors and minority shareholders of Company A. On day 1, Company A entered into an agreement and plan of merger with Company B. Company A’s board of directors (the donors abstaining) approved the merger and recommended it to the shareholders. On day 6, Company B made its tender offer. By day 34, more than 50 percent of the shareholders had tendered their shares. On day 43, the donors donated some of their Company A stock to a charity, which in turn immediately tendered the stock to Company B. On day 46, Company B announced its acceptance of all the tendered shares and purchased all of the shares on day 47. The Tax Court found that the donors were taxable on the gain from the stock transferred to charity because by the date of the gift the donors’ interest had been converted from an interest in a viable corporation to a fixed right to receive cash. The Ninth Circuit Court of Appeals affirmed, holding that the transaction had “ripened” into a right to receive sale proceeds once 50 percent shareholder approval for the merger had been reached.
      3. The application of Revenue Ruling 78-197 also arose in Gerald A. Rauenhorst, et al. v. Commissioner, 119 T.C. No. 9 (2002). In that case, Arbeit (a partnership) owned warrants enabling it to purchase NMG stock. On September 28, 1993, WCP (a corporation) offered to purchase all NMG stock. On November 9, 1993 the partnership assigned some warrants to four charities. On November 19 Arbeit sold its remaining warrant to WCP, and the charities sold their warrants to WCP. On November 22, 1993, WCP and NMG agreed on a sale of all the NMG stock. The government argued that the bright-line test of Revenue Ruling 78-197 was not controlling. The court held that, based on the facts of the case and the “no legal obligation” test of Palmer and Revenue Ruling 78-197, there was no prearranged sale, and in the process took a very dim view of the government’s urging to ignore the ruling:

While this Court may not be bound by the Commissioner’s revenue rulings, and in the appropriate case we could disregard a ruling or rulings as inconsistent with our interpretation of the law, see Stark v. Commissioner, 86 T.C. 243, 251 (1986), in this case it is respondent who argues against the principles stated in his ruling and in favor of our previous pronouncements on this issue. The Commissioner’s revenue ruling has been in existence for nearly 25 years, and it has not been revoked or modified. No doubt taxpayers have referred to that ruling in planning their charitable contributions, and, indeed, petitioners submit that they relied upon that ruling in planning the charitable contributions at issue. Under the circumstances of this case, we treat the Commissioner’s position in Rev. Rul. 78‑197, 1978‑1 C.B. 83, as a concession. Accordingly, our decision is limited to the question whether the charitable donees were legally obligated or could be compelled to sell the stock warrants at the time of the assignments.

A footnote to the opinion states as follows:

The record indicates that no agreement was entered into by the donees before Nov. 19, 1993, the date they signed the warrant purchase and sale agreement. On Nov. 16, 1993, NMG’s legal counsel sent letters to each of the donees enclosing a warrant purchase and sale agreement. Those letters state that pursuant to the warrant purchase and sale agreement, the donees would agree to sell their reissued warrants to WCP and “to abstain from either exercising its Warrant or selling or otherwise transferring it to any other party through Dec. 31, 1993.” Certainly, the formality of having the donees enter into the warrant purchase and sale agreements suggests that they had not entered into any binding agreements before Nov. 19, 1993.

5. Back to the Bright Line.

a. Subsequent to Rauenhorst, the government reiterated its intention, generally, to follow its own rulings in litigation. In Private Letter Ruling 200230004, a husband and wife proposed to transfer 495 of 500 shares of a C corporation to a charitable remainder unitrust and asked whether the redemption would be treated as an assignment of income. The ruling first describes Palmer and Revenue Ruling 78-197 and then states as follows:

In the present case, at the time X shares are transferred to Trust, X will be under no legal obligation to redeem the contributed stock. There is no agreement among the parties under which X would be obligated to redeem, or Trust would be obligated to surrender for redemption, the stock. Trust is not legally obligated to accept any offer of redemption made by X. Accordingly, any redemption by X of the stock contributed by Grantors to Trust will be respected.

Based on the representations submitted and information described above, we conclude that a purchase by X of the stock transferred by Grantors to Trust will be treated as a redemption of the stock from Trust, and will not be treated as a redemption of stock from Grantors or a distribution by X to Grantors. Therefore, the sale or redemption by Trust of its X stock will not result in the capital gain in such sale or the redemption price being attributed for tax purposes to Grantors.

b. In Private Letter Ruling 200321010, a retired officer of a corporation intended to give shares of the corporation to a charitable remainder unitrust. The transfer would trigger an option under a shareholder agreement, giving the company the right to purchase the stock for a formula price. The ruling described the “bright-line” test of Palmer, cited Rauenhorst, and concluded as follows:

Consequently, the test for purposes of this ruling request, is whether the CRUT will be legally bound or can be compelled by Company to surrender the stock for redemption at the time of the donation. Here, X proposes to transfer the Company stock to the CRUT. Under the restrictions contained in each year’s stock restriction agreement, the CRUT must first offer the stock to Company at a set formula price should the CRUT propose to dispose of the shares. This provision amounts to a right of first refusal. However, it does not mean that the CRUT is legally bound or can be compelled by Company to surrender the stock to Company at the time of the donation. The information submitted contains no indication that the CRUT will be legally bound, or could be compelled by Company, to redeem or sell the gifted stock. That all or a portion of the gifted stock was subject to restrictions upon transfer to a third party by X, and thus by the CRUT following the transfer, does not give Company the ability to compel its redemption or sale from the CRUT. The CRUT is free to retain title to and ownership of the stock indefinitely.

Because the CRUT is not legally bound and cannot be compelled by Company to redeem or sell the stock, we conclude that the transfer of the Company stock by X to the CRUT, followed by any subsequent redemption of the stock by Company, will not be recharacterized for federal income tax purposes as a redemption of the stock by Company from X followed by a contribution of the redemption proceeds to the CRUT. See Palmer v. Commissioner, supra, and Rev. Rul. 78‑197, supra. The same principles apply if the stock is sold by the CRUT rather than redeemed by Company. Thus, provided there is no prearranged sale contract whereby the CRUT is legally bound to sell the stock upon the contribution, we conclude that any subsequent sale will not be recharacterized for federal income tax purposes as a sale of the stock by X, followed by a contribution of the sale proceeds to the CRUT. Accordingly, any redemption proceeds or sales proceeds received by the CRUT for the stock will not be treated as taxable income received by X.

See also Private Letter Ruling 200821024 to the same effect.

* 1. Redemption for a Promissory Note.

1. Generally. Redemptions from a public charity may be for cash or in exchange for the corporation's promissory note. In the case of redemption from a private foundation or charitable remainder trust, a continuing question is whether and under what circumstances the redemption can be for a note, because loans from a private foundation to a corporate disqualified person are impermissible self-dealing. Private Letter Ruling 9347035 approved an installment redemption under the corporate adjustment exception to self-dealing:

Furthermore, the proposed transaction provides for an installment payment arrangement for the redemption of shares with part of the purchase price being paid in cash at the time of the redemption and the balance, pursuant to the terms of the transaction, being payable quarterly thereafter for the remaining ten year installment payment term. Thus, the retention by B of the redemption notes evidencing A's obligation to pay the balance of the redemption price is a part of the redemption transaction and is not self-dealing under section 4941(d)(2)(F) of the Code.

Several years later, the Service revoked that ruling in Private Letter Ruling 9731034:

In your letter dated June 24, 1992, you were concerned with the tax consequences of a redemption of shares of common stock from B following the donation of such shares to B by C. Redemption was to be accomplished through extensions of credit by A, a disqualified person with respect to B.

On August 31, 1993, we issued a favorable ruling to B (PLR 9347035) on this request. Subsequent to the issuance of the ruling it was discovered that the ruling was contrary to Example 2 of section 53.4941(d)-3(d)(2) of the Foundation and Similar Excise Taxes Regulations. When B was informed of our intent to revoke the ruling, B indicated that the transaction was never entered into and asked that the ruling request be withdrawn. On October 27, 1994, we acknowledged the withdrawal of B's ruling request.

This letter formally revokes PLR 9347035.

The answer thus appears to be a resounding “no.”

2. Use of Probate Exception. It is clear that a redemption in exchange for a promissory note of a disqualified person is permissible if approved as part of the probate exception. See, e.g., PLR 9312024, PLR 9350038, PLR 9112012, PLR 9108024, PLR 9042030. These rulings approved redemption for a note, but without comment on whether subsequent note payments similarly would not be self-dealing. The answer should be that payments are permissible, and certainly that result is within the spirit of the rulings.

3. Distribution of Existing Notes. There are rulings approving the distribution of an existing note under the probate exception. In Private Letter Ruling 200729043, for example, a decedent’s revocable trust received notes of a disqualified person upon liquidation of a corporation. The trustee proposed allocating the notes to the share of a private foundation. The Service ruled that receipt of the notes by the private foundation would not be an act of self-dealing. See also PLR 199924069. None of these rulings involved a redemption or other “transaction” in the estate or trust that would be completed as part of the probate exception, but instead merely a discretionary allocation of an existing note. For that reason, some planners take little comfort from them, and particularly in light of the recent rulings approving the use of an LLC to receive and hold notes of a disqualified person.

4. Use of LLC.

a. Several recent rulings approved the use of an LLC to hold notes of a disqualified person, whether existing in an estate or trust or acquired by the estate or trust as part of a transaction completed under the probate exception. In each case, the LLC had a small number of voting units and a large number of nonvoting units, and the nonvoting units were distributed to the foundation. The foundation therefore had no “control” over the LLC for purposes of the indirect self-dealing rules of Treas. Reg. § 53.4941-1(b)(5).

b. In Private Letter Ruling 200635017, notes were contributed to an LLC and the notes were then purchased in a transaction approved under the probate exception. The facts giving rise to a favorable ruling were as follows:

B had three children: C, married to D, E, married to F, and G. C, E, D, and G are now deceased. D, F, and G are each referred to as a “Taxpayer” and collectively as the “Taxpayers.”

C, F, and G entered into a business transaction with family members (including trusts or other entities controlled by, or created for the benefit of, family members). Pursuant to these transactions, C, F, and G acquired a promissory note as consideration, each referred to as a “Note.” Each Note provides for annual interest at the mid-term Applicable Federal Rate, with principal due at the end of the note term.

Each Taxpayer created a single member limited liability company of which the Taxpayer is the sole member. Each of these entities is referred to as a “Company” and collectively as the “Companies.” Each Taxpayer contributed his or her Note to his or her Company, in exchange for which the Taxpayer received all of the voting units (“Voting Units”) and nonvoting units (“Nonvoting Units”) of his or her respective Company. Pursuant to C's and D's estate plans, D's estate currently owns the Voting and Nonvoting Units in C's Company. In addition, F (through her revocable trust) currently owns the Voting and Nonvoting Units in F's Company, and G's estate currently owns the Voting and Nonvoting Units in G's Company. Each taxpayer entered into a limited liability company agreement (“Company Agreement”) to govern his or her respective Company.

Taxpayers state that each Company will be engaged solely in passive investment activities; will not engage in the operation of any business enterprise; and at least 95 percent of the gross income of each Company will be derived from passive investments that will include, for example, interest and dividends.

Each Taxpayer created a charitable trust to be funded at his or her death. Each of these trusts is referred to as a “CT” and collectively as the “CTs.” Each CT has a 20-year term commencing at the Taxpayer's death, during which term the CT will annually pay a guaranteed annuity to one or more charitable organizations.

Each Taxpayer has also created a revocable trust, separate and distinct from the Taxpayer's CT. Taxpayers state that each Taxpayer has provided in his or her revocable trust that at the Taxpayer's death, the Nonvoting Units owned by the Taxpayer will be allocated to the CT created by that Taxpayer. As a Nonvoting Unit holder, the CT cannot be required by the Company or its members, under the Company Agreement, to make any capital contributions or take any other actions. Nor does the CT have a right to force any distributions from the Company. Rather, under the Company Agreement the CT only has a right to receive distributions (in proportion to its ownership interest) when the Company dissolves or otherwise chooses to make distributions. The Taxpayer's Voting Units will be bequeathed to or in trust for the benefit of the Taxpayer's descendants.

Pursuant to an agreement (the “Option Agreement”), each Taxpayer (and his or her revocable trust) granted his or her children and a business entity controlled by the Taxpayers and their families (collectively, the “Option Holders”) an option (the “Option”) to purchase one or more specific assets (including the Note and any of the Nonvoting Units) (collectively, the “Option Assets”) from the then current owner of the Option Assets, including the Company or the Taxpayer's estate or revocable trust. The Option Assets will not include any of the Voting Units. The Option Agreement provides that the Option Holders may purchase some or all of the Option Assets for a purchase price equal to the fair market value of such Option Assets as determined for federal estate tax purposes in the Taxpayer's estate at any time within nine months of the Taxpayer's death (the “Option Term”). The Option Holders will be required to pay the purchase price for the Option Assets in cash, marketable securities, or a combination of both.

With respect to any Option Assets to be purchased from the Taxpayer's estate or revocable trust, before the expiration of the Option Term, Taxpayers state that their estates or revocable trusts will petition a court of competent jurisdiction for approval of both the Option Holders' exercise of their options, as well as the tendering and receipt of consideration pursuant to each Option Agreement. Taxpayers state that the exercise of the Options by the Option Holders, the sale and purchase of Option Assets, and the tendering and receipt of consideration related thereto, will occur before the end of the period reasonably required by the executors or trustees to perform the ordinary duties of administration necessary for the settlement of the Taxpayers' estates and before the Taxpayers' revocable trusts are treated as trusts under section 4947 of the Code. Taxpayers state that the purchase of the Option Assets owned by the Taxpayers' estates or revocable trusts pursuant to each Option Agreement will be contingent upon receipt of approval from a court of competent jurisdiction.

c. In Private Letter Ruling 201407023, the Service approved under the probate exception the distribution to a foundation of nonvoting units in an LLC already holding the note of a disqualified person, holding that neither the distribution of the LLC units nor the retention of the units by the foundation would be self-dealing, even though the sole asset of the LLC would be the note and payments on the note. The principal facts were as follows:

You are an individual. After the death of the later to survive of you or your wife, your estate plan stipulates that an ownership interest in LLC will go to Foundation, a private foundation founded by you, as discussed below.

You made capital contributions to and currently own all of the membership units, voting and nonvoting, of LLC, a Limited Liability Company, which is a disregarded entity for federal income tax purposes. LLC is managed by the members owning voting units (Managing Members). A Managing Member's signature is sufficient to bind LLC. Managing Members are authorized to invest or reinvest available funds in investments consistent with the purposes of LLC, to vote any stock or other voting security, to exercise the rights of a general partner, to expend LLC funds to borrow as they deem appropriate, to collect obligations payable to LLC, and to generally perform the duties of running LLC. Managing Members will also make distributions from time to time in such amounts as they decide after considering the needs of LLC and their fiduciary obligations to all members. All distributions will be made to all unit holders, voting and nonvoting, ratably in proportion to ownership of units. These rights and responsibilities are designated solely to the Managing Members. LLC may only be dissolved with the written approval of members holding at least fifty percent of the units in each member class, voting and nonvoting.

The sole asset of LLC is a note from your daughter. The only income derived by LLC will be income from the note. Taxpayer represents that LLC is engaged solely in passive investment activities and does not engage in, and will not be engaged in, the operation of any business enterprise. The promissory note from your daughter bears interest at the long-term federal rate determined under § 1274(d) in effect at the time you and your daughter entered into the agreement. The principal of the note is due at the end of the note's term. This note will continue to be an asset of LLC, and the interest therefrom will be LLC's sole income. You propose to transfer at death a non-voting interest of LLC to Foundation, but not a voting interest, through either your or your wife's estate. LLC will have multiple owners and will not be a disregarded entity.

This ruling was issued to the donor. A companion ruling was issued to the foundation (PLR 201407021).

d. In Private Letter Ruling 201446024, an estate held notes from the sale of assets to an irrevocable trust created by the decedent. The personal representative proposed creating a new LLC with voting and nonvoting units, contributing the notes to the LLC, and transferring the nonvoting units to the decedent’s foundation. The Service ruled that the creation and funding of the LLC pursuant to the probate exception, the LLC’s retention of the note and the receipt and distribution of payments on the note, and the foundation’s ownership of the nonvoting units would not constitute self-dealing. The basic facts were as follows:

During life, Decedent formed Company, and at its inception, received both voting and nonvoting units in Company. Subsequently thereafter, Decedent formed Irrevocable Trust and sold approximately 85 percent of his interest in Company, and in exchange, received a promissory note (“Note”). Note evidenced Irrevocable Trust's obligation to pay Decedent, principal and interest at regularly prescribed intervals.

As part of Decedent's estate planning, Decedent executed a will and formed Revocable Trust. The terms of the will provided that upon Decedent's death, the residue of Decedent's estate, including Note, would pass to Revocable Trust and thereafter the assets would be distributed to several beneficiaries including Foundation. Accordingly, at Decedent's death, the Note became part of the residuary estate and the obligor of Note continued to be Irrevocable Trust.

The Executor/Trustee has represented that the current beneficiaries of Irrevocable Trust are all family members of Decedent and thus their combined beneficial interest in Irrevocable Trust is greater than 35 percent. Because Irrevocable Trust is the obligor of Note and Foundation will become the creditor of Note, the Executor/Trustee has represented that an act of self-dealing under I.R.C. § 4941 will result when Note is transferred to Foundation.

As such, the Executor/Trustee proposes to contribute Note to a new entity LLC for which the estate will receive 100 voting and 9,800 non-voting units in LLC. Simultaneously, Executor/Trustee, in his individual capacity, would contribute cash equal to 1 percent of the value of LLC in exchange for 100 non-voting units in LLC. Further, Executor/Trustee, in his individual capacity, would buy the 100 voting units in LLC from the Estate for cash equal to a purchase price determined by a qualified appraisal. In the end, Foundation would receive cash and 9,800 non-voting units of LLC instead of Note from the Revocable Trust. LLC's amended operating at Article 6, section 6.1, provides in essence, that upon any default on the Note, LLC “shall immediately take all necessary actions to foreclose on and collect payment of the Note from the Borrower and/or Guarantor.” Executor/Trustee will seek court approval from the probate court regarding the sale of the Note to LLC and the sale of voting units to Executor/Trustee.

You have represented that LLC will engage in only passive investment activities, and not in the operation of any business enterprise, and at least 95 percent of its gross income will be from passive investments including interest and dividends. LLC's operating agreement allocates profits and losses in proportion to the number of units held by each member and all payments received on Note will be distributed annually to members. Any amendment to LLC's operating agreement would require consent of all members and an unqualified opinion of counsel that such an amendment would not jeopardize any member's tax status.

1. CHARITABLE GIFTS OF PARTNERSHIP (OR LLC) INTERESTS
   1. Generally.
      1. One of the tax benefits of having a partner that is a charitable entity is its tax-exempt status. When a charitable entity holds a partnership interest, however, due regard should be given to unrelated business taxable income and excess benefit transactions. Further, if the charitable entity is a private foundation, planners should consider the rules relating to self-dealing transactions and excess business holdings. For purposes of this section, unless otherwise noted, it is assumed that the charitable partner is a public charity, and the assets in the partnership do not give rise to unrelated business taxable income, excess benefit transactions, or private inurement issues.
      2. If a donor makes a charitable contribution of a partnership interest to charity, the donor may be entitled to a charitable deduction (for income and transfer tax purposes). If the partnership interest is appreciated (outside basis is less than the fair market value), then the amount of the charitable deduction may be reduced under IRC § 170(e). If a partnership interest is sold in a taxable transaction, the character of the gain recognized by the selling partner is capital subject to recharacterization as ordinary income under IRC § 751(a) for gain attributable to “hot assets” (ordinary income items like unrealized receivables, inventory items, etc.) held by the partnership. IRC § 741.
      3. The Code provides that all contributions of “ordinary income property,” regardless of the type of charitable done, must be reduced by the amount of ordinary income that would have resulted if the donor had sold the contributed property at its fair market value at the time of the contribution. IRC § 170(e)(1)(A). For these purposes, ordinary income includes any gain attributable to “hot assets” of the partnership, and any short-term capital gain attributable with respect to the partnership interest. The capital gain attributable to a partnership interest will be short-term or long-term depending on the transferor partner’s holding period in the partnership interest. Notwithstanding the unitary basis requirement for partnership interests, the Treasury Regulations provide that a partner can have multiple holding periods for a single partnership interest. Treas. Reg. § 1.1223-3.
      4. The Code further provides that a donor’s contribution of capital gain property will be further reduced by “the amount of gain which would have been long-term capital gain” if the donor contributes the property to a private foundation (other than private operating foundations, distributing foundations, and foundations with a common fund). IRC § 170(e)(1)(B). If the donor contributes the partnership interest to a public charity, the donor will be entitled to a charitable deduction equal to the fair market value of the interest (assuming there is no reduction for ordinary income due to “hot assets” in the partnership). However, the income tax deduction will be limited to 30 percent (not 50 percent) of the donor’s contribution base for the taxable year. *See* IRC §§ 170(b)(1)(A), 170(b)(1)(C), and § 170(b)(1)(C)(i). A donor may avoid limiting the deduction to 30 percent if the donor elects to be subject to IRC § 170(e)(1)(B). *See* IRC § 170(b(1)(C)(iii). Pursuant to the election, the amount of the contribution is reduced by the amount that would have been long-term capital gain (if the contributed property had been sold for its fair market value at the time of contribution). If the election is made, then the contribution is subject to the 50 percent limitation, rather than the 30 percent limitation.
      5. A charitable contribution of a partnership interest generally will not cause the donor to recognize gain or loss. However, there may be gain if, as a result of the transfer, there is a deemed reduction in partnership liabilities under IRC § 752(d) or if the partnership interest is subject to a liability in excess of outside basis, so that the transfer is considered a part sale/part gift. In such circumstances, the donor will recognize gain (but not loss) for the excess of any liability over the outside basis in the partnership interest. Treas. Reg. § 1.1001-1(e), *Diedrich v. Commissioner*, 457 U.S. 171 (1982), *aff’d* 643 F.2d 499 (8th Cir. 1981), *rev’g* T.C. Memo 1979-441, 29 T.C.M 433(gain recognized with a net gift where gift tax paid by the donees exceeded the basis of property transferred), *Estate of Levine v. Commissioner*, 72 T.C. 780 (1979), *aff’d*, 634 F22d 12 (2d Cir. 1980) (gain realized on net gift of encumbered property).
      6. In addition, ordinary income may be triggered under IRC § 751(a) if the partnership owns hot assets if there is a deemed transfer of partnership liabilities, and the contribution may also accelerate inherent gain in an installment obligation owned by the partnership. *See* Rev. Rul. 64-102, 1984-2 C.B. 119 (shift of liability upon the admission of a new partner resulting in income to the partners under IRC § 751(b), Tennyson v. United States, 76-1 USTC ¶9264 (W.D. Ark. 1976), and Rev. Rul. 60-352, 1960-2 C.B. 208 (gift of interest in partnership holding an installment receivable is a disposition of the receivable accelerating the gain).
   2. Donor Issues.
      1. Phantom Income. Charitable gifts of interests in partnerships or limited liability companies can sometimes result in surprising and unfavorable tax consequences to the donor. The gift may result in the realization of ordinary income by the donor if the partnership has unrealized receivables or appreciated inventory, or if there is any investment tax credit subject to recapture. See generally IRC §§ 47 to 50 and 751(a).
      2. Bargain Sale Rules. The so-called “bargain sale rules” apply to gifts of interests in partnerships with outstanding indebtedness, even if the indebtedness is nonrecourse and unsecured. The partner is treated as having received payment for his or her entire share of partnership liabilities. See IRC § 752; Treas. Reg. § 1.752-1(d). See also Rev. Rul. 75-194, 1975-1 C.B. 80. This can result in “phantom” capital gain income to the donor.
      3. Valuation and Substantiation. A charitable gift of an interest in a partnership or LLC is generally treated as a gift of a capital asset, so a gift to a public charity generally would qualify for a full fair market value deduction. The Service quite properly asserts, however, that all the same valuation discounts promoted by donors of noncharitable gifts also apply to charitable gifts, so the appraised value of the interest transferred generally would be 10 to 50 percent less than the undiscounted value based on the value of the underlying assets. Gifts of such interests are subject to the “qualified appraisal” rules.
         1. After much anticipation, on August 2, 2016, the US Department of the Treasury issued proposed regulations under IRC § 2704 on the valuation of interests in family-controlled entities for transfer tax purposes. If finalized in their current form, these new rules will likely substantially increase estate taxes payable by the estates of owners of family-controlled businesses, farms, real estate companies and investment companies. The regulations would overturn well-settled law that has allowed valuation discounts to be applied to these interests and would substantially affect transfers of interests in closely-held entities, including transfers to charity. Treasury personnel have stated that the proposed regulations are not intended to affect the valuation of transfers to charity.
         2. The new rules are in proposed form and are not effective until finalized. This likely will not occur until sometime in 2017 at the earliest. Proposed regulations can be altered before they are finalized, sometimes significantly. The finalization of proposed regulations can take a long time, as can be seen from the 2008 proposed regulations cited above. As a result, no one can be certain of the final form that these rules will take or when they will become effective, if at all.
      4. Prearranged Sale Rules. Although most of the reported cases and rulings deal with prearranged sales or redemptions of stock, the same principles would apply to gifts of partnership interests.
   3. Donee Issues.
      1. Unrelated Business Income.
         1. A tax-exempt organization, including a private foundation, pays tax on its unrelated business taxable income (“UBTI”). IRC § 511. UBTI is income from activities that: (1) are regularly carried on, (2) rise to the level of a trade or business, and (3) are substantially unrelated to the organization’s exempt purposes. IRC §§ 512, 513. UBTI does not include passive income such as dividends, interest, most rents from real property, and gains from the sale of property (other than dealer property). IRC § 512(b). If a tax-exempt organization is a partner in a partnership that regularly carries on a trade or business that is unrelated to the exempt purpose of the organization, such organization shall, in computing its UBTI, include its share of partnership gross income from the unrelated trade or business and its share of partnership deductions directly connected with such gross income, subject to the exceptions for passive income. IRC § 512(c).
         2. Unlike the case with shares of S corporations held by tax-exempt organizations, a tax-exempt partner’s share of partnership income and gain is not necessarily treated as unrelated business income. Instead, there is something of a “look through” rule. The charitable organization must include in its unrelated business income only its share of the partnership's income attributable to unrelated trade or business activities carried on by the partnership. IRC § 512(c). In other words, for purposes of this rule, the partner is treated as engaged in the same activities of the partnership. The tax-exempt partner’s share of the partnership's dividends, interest, rents, royalties, and other “passive” income retains its tax-free character.
         3. The exclusion of rent from UBTI does not apply if the determination of rent depends in whole or in part on the income or profits derived by any person from the property leased (other than an amount based on a fixed percentage or percentages of receipts or sales). IRC § 512(b)(3)(B)(ii). In other words, rent is not passive income if it represents a portion of the tenant’s net income or profit. Some commercial leases (including many shopping center leases) provide for both a fixed minimum rent and an additional percentage of gross receipts or sales from tenants, less agreed upon exclusions such as real estate taxes, property insurance, and common area maintenance paid by such tenants. To avoid UBTI for tax-exempt organizations owning rental property with such leases (or owning partnership interests where the partnership owns such rental property), care should be taken to craft a rental formula that avoids rent being treated as an interest in the profits of the tenant. For example, if percentage rent contains exclusions from gross receipts, such exclusions should be tied to expenses of the property and not to other activities of the tenant’s business.
      2. Debt-Financed Income.
         1. The exclusion from UBTI for income from passive activities is limited when the property giving rise to the income is financed by “acquisition indebtedness,” that is, indebtedness incurred to purchase or improve the property (or indebtedness incurred before or after a purchase or improvement that would not have occurred but for such purchase or improvement). IRC §§ 514(a) and 514(c)(1). Where property is acquired (including by gift or bequest) 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 organization does not assume or agree to pay such indebtedness. IRC § 514(c)(2)(A).
         2. When there is acquisition indebtedness, a portion of the gross income (including capital gain) generated by the property is UBTI. Such portion is the ratio of the average acquisition indebtedness over the average adjusted basis in the property during the year. However, the acquisition indebtedness rule does not apply to the extent that the use by the organization of the mortgaged property is substantially related to its exempt purposes. IRC § 514(b)(1)(A).
         3. Income or gain from debt-financed property is taxable in the same proportion that the acquisition indebtedness bears to the organization’s income tax basis in the property. IRC § 514(a). The same basic rules apply to a tax-exempt partner’s share of partnership debt-financed income or gain.
         4. Under the so-called “old and cold” exception, if mortgaged property (or an interest in a partnership that owns mortgaged property) is acquired by the organization as a result of a bequest or devise from a deceased donor, the indebtedness is not treated as acquisition indebtedness during the 10-year period following the date of acquisition. Where mortgaged property (or an interest in a partnership that owns mortgaged property) is acquired by the organization as the result of a gift from a living donor, the indebtedness is not treated as acquisition indebtedness during the 10-year period following the date of acquisition if (i) the mortgage was placed on the property more than five years before the date of the gift and (ii) the donor owned the property for more than five years before the date of the gift. IRC § 514(c)(2)(B).
      3. Payments of Income Tax. The charitable partner may be subject to income tax on its share of partnership unrelated business income, without regard to actual distributions from the partnership. It is important that the partnership agreement or LLC operating agreement require the entity to make distributions in an amount at least sufficient to pay any unrelated business income tax. A well-represented charitable donee will insist on indemnification if such distributions are insufficient to pay any tax.
      4. Capital Assessments. Although limited partners and members of LLCs generally are liable for partnership debts and expenses only to the extent of their investment, the terms of the partnership agreement or operating agreement can require partners or members to make additional capital contributions or other payments. The charitable donee should carefully consider these and other cash flow issues before accepting a gift.
      5. Environmental Liabilities. The interest of a limited partner or a member of an LLC is personal property, even if the entity owns real property. The partner or member should thus not constitute an “owner” within the meaning of federal and state environmental laws, but in some cases the partner or member could be deemed an “operator” of property. A prudent charitable organization will undertake at least limited environmental due diligence before accepting an interest in any entity owning real property.
      6. Donor Indemnities. With respect to any of these potential liabilities, a charitable donee may wish to consider requesting an indemnity from its donor.
   4. Basis Shifting with Charitable Entities.
      1. When a donor makes a gratuitous transfer of a partnership interest to a donee and the donee is not a deemed to be the donor for income tax purposes (e.g., a grantor trust of the donee), then generally no gain or loss is recognized on the transfer. This assumes that the transfer is not considered a part sale/part gift transfer. Gain, possibly ordinary income under IRC § 751(a), but not loss, may be recognized with a part sale/part gift, but only when the sale price exceeds the outside basis of the partnership interest. SeeIRC § 751(a) and Rev. Rul. 60-351, 1960-2 C.B. 208 (gift accelerated gain on an installment obligation). The sale price would be deemed to include any partnership liabilities deemed to have been transferred. See IRC § 752(d), Rev. Rul. 77-402, 1977-2 C.B. 222 (grantor trust converting to a taxable trust), and Madorin v. Commissioner, 84 T.C. 667 (1985). The donee has a transferred basis in the interest received, increased by any gift tax paid. IRC § 1015(d). The transferred basis is, however, limited to fair market value of the partnership interest, for purposes of determining a loss. IRC § 1015(a). Given the foregoing limitation with respect to losses, valuation discounts could, in fact, limit the ability of the donee to recognize a portion of a subsequent loss. In such cases, the partner might be better off having received distributions of partnership assets in-kind and selling such assets, rather than selling the partnership interest itself. The tax difference between selling a partnership interest and selling distributed assets is discussed in more detail later in this outline.
      2. If the donor transfers only a portion of his or her partnership interest, it stands to reason that only a portion of the donor’s unitary outside basis is transferred. One would assume that a pro rata portion of the donor’s outside basis would also be transferred to the donee. In other words, if a donor owns a partnership interest having an outside basis of $100 and the donor gifts 55 percent to a donee (who is not a grantor trust), then the donee will now own a partnership interest with an outside basis of $55. Surprisingly, that does not seem to be the case.
      3. In Revenue Ruling 84-53, 1984-1 C.B. 159, the IRS ruled in the context of calculating outside basis of a transferred partnership interest, “the basis of the transferred portion of the interest generally equals an amount which bears the same relation to the partner's basis in the partner's entire interest as the fair market value of the transferred portion of the interest bears to the fair market value of the entire interest.” The ruling relies on Treas. Reg. § 1.61-6(a) which provides that when a part of a larger property is sold, the basis of the entire property shall be equitably apportioned among the several parts for purposes of determining gain or loss on the part sold. Under this calculation, if the gift of the 55 percent partnership interest carries a valuation discount (which it should since that reflects fair market value), then the 55 percent interest would actually transfer less than $55 of basis.
      4. For example, assume a donor has a partnership interest that has a fair market value of $200 (the value represents a controlling interest in the partnership but reflects some discounts for lack of marketability) and an outside basis of $100. The donor gifts 45 percent of his or her partnership interest to a donee. Assume further that 45 percent transfer carries a valuation discount of 30 percent. As a result, the gift tax value (fair market value) of the transfer is $63 (reflecting a 30 percent discount on an interest which has a value before the discount of $90). Under the formula of Revenue Ruling 85-53, the transferred interest has a fair market value of $63, and the fair market value of the entire interest is $200, resulting in only 31.5 percent of the donor’s original basis having been transferred ($63/$200). After the transfer, the donee owns 45 percent of the partnership interest with an outside basis of $31.50, and the donor retains 55 percent of the partnership interest but has an outside basis of $68.50.



It should be noted, that had the valuation of the donor’s interests prior to the transfer included the same valuation discount (30 percent), then the foregoing formula would have resulted in $45 of basis apportioned to the transferred interests (a proportionate percentage). It’s the fact that the value of the transferor’s entire portion has no (or less) valuation discount that causes the “distortion.”

* + 1. As illustrated above, Revenue Ruling 84-53 provides that when a partner transfers (gratuitous or taxable) a partnership interest and the interest carries a valuation discount, a disproportionately smaller amount of basis is transferred to the transferee. Further, as discussed herein, a tax basis “shift” is predicated upon the partnership distributing a higher inside basis asset (in-kind) to a partner whose outside basis in the partnership is lower than the distributed asset. With these rules in mind, a gift of a non-controlling partnership interest to a charitable entity may provide significant tax basis planning opportunities.
    2. Consider the following highly simplified hypothetical:
       1. Taxpayer creates a limited partnership and contributes to the partnership the following assets:
          1. Asset A with a zero basis and fair market value of $100; and
          2. Asset B with $100 basis and fair market value of $100.
       2. As a result of the contribution, the taxpayer takes back a 1 percent general partnership interest and 99 percent limited partnership interest. Assume another person contributes and owns a nominal interest in the partnership to ensure that the entity is a partnership for income tax purposes, rather than a disregarded entity (see the discussion later in these materials). For purposes of this hypothetical, ignore the existence of this nominal partner. Outside basis in the taxpayer’s partnership interest is $100 and his capital account is $200. Assume for purposes of this example that the taxpayer’s interest (prior to any transfer) in the partnership remains at $200 (no valuation discounts).
       3. Taxpayer donates 50 percent of the limited partnership interest to charity (retaining the 1 percent general partnership interest and a 49 percent limited partnership interest). Assume the value of the limited partnership interest carries a 50 percent valuation discount. In other words, the value for income and gift tax purposes is $50. Assuming the charitable entity is a public charity and the partnership does not have any “hot asset” under IRC § 751, the taxpayer will receive a $50 income tax deduction. IRC § 170(e)(1)(A).
       4. Under Revenue Ruling 84-53, the basis of charity’s partnership interest is only $25, and taxpayer’s outside basis is $75:



* + - 1. Notwithstanding the foregoing, charity’s capital account, under the Treasury Regulations is $100. Treas. Reg. §§ 1.704-1(b)(2)(iv)(l) and 1.704-1(b)(5), ex. 13.



* + - 1. At least 7-years after the contribution of the assets, assuming the assets remain in the partnership and there has been no change in the values, the partnership liquidates charity’s interest (according to its capital account balance) and distributes Asset B ($100 basis and fair market value of $100) to charity. Assume the LLC has a section 754 election in place at the time of the distribution of Asset B.
      2. The basis of Asset B owned by charity has its basis replaced by charity’s outside basis in the partnership. As a result, Asset B’s basis is $25. Charity can then sell the Asset B and recognize the gain in a tax-exempt environment.
      3. With the section 754 election, the $75 of basis reduction (basis strip) results in an increase in the basis to Asset A under IRC § 734(b). Asset A’s basis goes from zero to $75. The basis adjustment under section 734(b) is to partnership property, so if the partnership sells Asset A, the basis increase will benefit all of the remaining partners (the taxpayer and any transferees of the taxpayer’s retained interest).
  1. Creating Basis and Shifting Charitable Deductions.
     1. Under a number of circumstances, the charitable income tax deduction is limited to the basis of the property contributed to charity. For example, when a donor makes a contribution of tangible personal property to a charitable organization where the use by the charity is unrelated to the charitable function or purpose of the organization, the deduction is reduced by the long-term capital gain had the donor sold the property on the date of contribution. IRC § 170(e)(1)(B)(i). For example, a gift of an appreciated work of art to a public charity that is not a museum or whose function and purpose is totally unrelated to art would result in an income tax deduction equal to tax basis.
     2. Consider the following scenarios:
        1. Donor owns a $10 million work of art with zero basis. Donor wishes to contribute the art to a public charity for an unrelated use. If the donor gives the art to the charity during his or her lifetime, then the donor will receive no income tax deduction.
        2. If donor dies and bequeaths the art to charity in his or her Will, then the art will get a “step-up” in basis, and the donor’s estate will get the benefit of a charitable estate tax deduction but not an income tax deduction.
        3. If donor dies and bequeaths the art, outright, to his or her surviving spouse, then the art will get a “step-up” in basis, and the estate will get the benefit of the marital deduction for the artwork passing to the spouse. The surviving spouse can subsequently gift the art to the charity, and the surviving spouse would get the benefit of a $10 million charitable income tax deduction.
        4. What if the spouse is unable to effectively use the resulting income tax deduction? Is there some way of shifting those charitable deductions to other family member who would make better use of the deductions?
     3. When a partnership makes a charitable contribution of property, it is not considered a partnership expense. Treas. Regs. § 1.702-1(a)(4). Deductions for previous charitable contributions are not included in the computation of partnership taxable income. IRC §§ 702(a)(4), 703(a)(2)(C). Consequently, deductions for charitable contributions are not subject to the limitations of IRC § 704(d). However, they are taken into account by the partners, and each partner determines separately whether she has exceeded the applicable limitation on previous charitable deductions. Furthermore, charitable contributions must be appropriately classified so that limitations imposed on the deductibility of certain classes of such contributions may be applied. In PLR 8753015, the IRS held that charitable contributions made by a partnership are not subject to limitation by the at-risk rules and the passive loss limitations. Citing section 1.703-1(a)(2)(iv) of the Treasury Regulations, the IRS explained that each partner separately, rather than the partnership, is treated as having made the contribution; the resulting charitable contribution deduction, thus, is not allocable to the partnership's business and is not allocable to an activity to which those rules applies. Rather, the charitable contribution is accounted separately by the partners under IRC § 702(a)(4). Furthermore, the Treasury Regulations under IRC § 704(d) (general limitation on the allowance of losses) do not list charitable contributions among the specific items of loss which are subject to the IRC § 704(d) limitation (limited to basis). Under IRC § 705(a)(2)(B), a partnership contribution of property to charity reduces each partner’s outside basis by the amount of the partner’s share of the partnership’s basis in the contributed property, but not below zero. Rev. Rul. 96-11, 1996-1 C.B. 140.
     4. Importantly, a partner’s charitable deduction for the contribution of appreciated property by the partnership does not seem to be limited to his or her share of the partnership’s basis in the assets. See PLR 8405084. Thus, contributions of appreciated property by partnerships preserve the tax benefit of receiving a deduction at fair market value for the contribution of appreciated property; the unrealized appreciation is not transferred to the partner’s interest in the partnership.See also PLR 200208019, in which the IRS considered whether the members of a partnership were entitled to a charitable deduction on account of the partnership’s grant of a conservation easement to a charitable organization. The IRS concluded that each partner was entitled to a charitable deduction equal to each partner’s distributive share of the gift.
     5. Reconsider the foregoing scenario with the surviving spouse who now owns the $10 million of art with a tax basis equal to fair market value. The spouse contributes the $10 million of art to a partnership and the spouse’s child contributes highly-appreciated (zero basis) property of equal value (perhaps another work of art). The spouse and the child each take back a 50 percent ownership interest in the partnership. The spouse’s outside basis is $10 million, and the child’s outside basis is zero. IRC § 722. If the partnership then donates the artwork contributed by the spouse to the charity and then allocates the income tax deduction equally to the 2 partners, the spouse and child would each be able to claim $5 million of charitable income tax deduction. Under IRC § 705(a)(2)(B), spouse’s outside basis in his or her partnership interest would be reduced by $5 million. The child’s outside basis remains at zero, but the child would still be able to claim a $5 million charitable income tax deduction.
     6. IRC § 704(c)(1)(A) provides “income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution.” Could the IRC § 704(c) rules could prevent the result in the example above because the charitable deduction allocated to the child was effectively created by the spouse’s contribution? It does not seem so. By its terms, the Treasury Regulations provide that “Section 704(c) Property” only includes property if “at the time of contribution its book value differs from the contributing partner's adjusted tax basis” (book value meaning fair market value at the time of contribution). Treas. Reg. § 1.704-3(a)(3)(i). The spouse partner in the foregoing example did not contribute property with any built-in gain or loss because the basis equaled fair market value at the time of contribution.See PLR 9616015 (Because fair market value of timber rights contributed by an Alaska native entity to a partnership was the same at the time of contribution as when they were granted, the rights did not constitute IRC § 704(c) Property and the partnership’s items of income, gain, loss, and deduction are allocable under IRC § 704(b)). Furthermore, the IRC § 704(c) methods of allocation (traditional, traditional with curative allocations, and remedial allocations) in the Treasury Regulations (Treas. Reg. § 1.704-3(b), -3(c), and -3(d)) focus exclusively on allocating built-in gain or loss if the partnership sells the contributed property or if the contributed property is subject to amortization, depletion, depreciation or other cost recovery. Nothing under IRC § 704(c) and the Treasury Regulations would seem to prevent the partners from sharing the charitable income tax deduction, as described in the example above. The mixing bowl rules under IRC §§ 704(c)(1)(B) and 737 would not apply either because that requires a distribution of the contributed property to another partner or a distribution of other property to the contributing partner.
  2. Charitable Family Limited Partnership.
     1. Purpose and Mechanics.
        1. The purpose of a charitable partnership is to enable a donor to:
           1. Make a larger charitable gift than the donor would feel comfortable making otherwise;
           2. Make a charitable gift when the donor is making substantial gifts to the donor’s descendants; and
           3. Sell appreciated assets without incurring gain. In the discussion below a transaction with the donor’s children is generally assumed. However, the transaction may also be undertaken with grandchildren or other descendants, or with trusts for the benefit of descendants.
        2. The donor creates a limited partnership. The other initial partner may be the donor’s spouse or children. Generally, forming a limited partnership between a donor and spouse is better than involving children because it reduces the opportunity for the IRS to claim that the donor made a gift upon the formation of the partnership. The partnership may have 10,000 units of which 100 would be general partnership units and 9900 would be limited partnership units. Thus, 99 percent of the “equity” in the partnership is represented by the limited partnership units while 1 percent of the partnership controls it.
        3. The partnership can be funded with whatever assets the donor desires. Ideally appreciated assets would be used and care must be taken to avoid the investment company rules. IRC § 721(b) provides that provides that gain is realized on the contribution of property to a partnership if the partnership would be treated as an “investment company” under IRC § 351(e). IRC § 351(e) and the Treasury Regulations provide that any contributions will be deemed to be a transfer to an investment company if the transfer results, directly or indirectly, in diversification of the transferor’s interests, and the transferee is, in pertinent part, a corporation more than 80 percent of the value of whose assets are held for investment and are stocks or securities, or interests in regulated investment companies, or real estate investment trusts.
        4. The effects on valuation of funding options should be considered as well. For example, if real property is contributed, more different parcels usually create lower values, e.g. a partnership that contains some undeveloped land and rental properties of various types may be discounted more than a partnership that owns only one kind of real estate.
        5. The donor would contribute the 9900 limited partnership units to a charity. A community foundation is often a good choice because through the foundation the donor is able to benefit multiple charitable beneficiaries. Private foundations are not a good choice because of the self-dealing limitations nor are public charities that are controlled or substantially influenced by the donor.
        6. IRC § 170 allows the donor to receive and income tax deduction for the contribution of limited partnership units so long as the contribution is not viewed as being of a partial interest. That is, in order for an income tax deduction to be available the partnership must be respected so that the charity is viewed as receiving partnership units rather than a partial interest in the assets of the partnership. For that reason, the charity should receive the full benefits of the units it receives including income distributions, and the partnership formalities should be followed completely. In general, the same considerations as a donor would follow to minimize or avoid the application of IRC § 2036(a)(1) (transfers with retained enjoyment or control) in the FLP context are applicable here. The amount of the donor’s income tax deduction depends on the fair market value of the units which must be determined by appraisal. See Treas. Reg. § 1.170A-13.
        7. Most charities do not desire to retain limited partnership interests and thus will want to sell the units. Experience suggests that the most likely purchasers will be one or more members of the donor’s family. That may be the children, grandchildren, or trusts for their benefit. The charity should be willing to sell the units for their fair market value which is appraised value. The net effect is that the charity receives appraised value and the children, or other purchasers of the units, receive the value of the partnership above the appraised value.
     2. Economics of the Basic Transaction.
        1. With Children.
           1. Is the transaction beneficial to the family and to the charity? Stated differently, is it a good deal? To illustrate, let us begin with a donor with $1,000,000 in cash. The donor, who has used her gift tax exemption, intends to give $700,000 of that to charity and $300,000 to her children. Of the $300,000 for the donor’s children, gift tax of about $86,000 will be owed netting to the children about $214,000.
           2. The $700,000 given to charity will remove $700,000 from the donor’s estate but will save the donor about $280,000 in income tax (assuming a combined 40 percent federal and state rate). If the donor took that $280,000 and paid gift tax of $80,000 (assuming a 40 percent tax rate) the donor’s children would receive about $200,000. So, the donor’s children would receive $214,000 plus $200,000 for about $414,000 in this transaction. Charity would have $700,000.
           3. The same transaction with the partnership would have the following results. First, assume that the partnership is funded with $1,000,000 and that the 9900 limited partnership units are valued at $700,000 (approximately a 30 percent discount). The donor receives a $700,000 income tax deduction upon making the gift to charity which is same as above. If the donor takes the income tax savings and gives them to the children, they will net $200,000.
           4. If the children purchase the partnership units from the charity for $700,000, the units would have $990,000 of underlying value. If (when) the donor transfers the 100 general partnership units to the children that value may be unlocked. If it is unlocked, the children will have paid $700,000 for something worth $990,000.
           5. The total benefit to the children is, therefore, $200,000 from the charitable deduction and $290,000 from the unlocking of partnership value for a total of $490,000. The children are ahead by $76,000. Of course, consideration should be given to the children’s adjusted basis.
        2. With Grandchildren or Trusts for Descendants.
           1. The transaction becomes more favorable when assets are moved down more than one generation. To illustrate, a donor with $300,000 of cash will pay $86,000 in gift tax and $61,000 in generation skipping tax (at the 40 percent rate, tax exclusive because a direct skip), leaving the children with $153,000. Similarly, the donor who makes a charitable gift of $700,000 and receives and income tax deduction of $280,000 may give only $143,000 to the grandchildren after payment of gift and generation-skipping transfer tax. Thus the grandchildren would receive $153,000 plus $143,000, which is $296,000.
           2. Recall that the yield of the charitable partnership transaction does not vary regardless of the purchaser of the limited units; if grandchildren or a trust for descendants is the purchaser, the benefit remains at $217,500 net of capital gains tax. The value of income tax deduction to the grandchildren remains $143,000. So the grandchildren receive if the partnership is used a total of $360,500. The increase to the grandchildren from using the partnership is $360,500 minus $296,000, which is $64,500. If the donor must sell assets to pay gift tax and generation-skipping transfer tax, the benefits are likewise substantially increased.
        3. Enhancement of the Transaction.
           1. If appreciated assets are used to fund the partnership, the transaction may be enhanced. If the assets are sold while the charity owns the limited units, the 99 percent of the gain realized by the partnership would be allocated to the charity and thus escape income tax. Under the disguised sale rules, a partner who contributes assets to a partnership must recognize gain from the sale of the assets within two-years; however, that rule causes the owner of the limited units to be taxed, in effect, rather than the donor/contributor.
           2. In almost every situation the assets inside the partnership should be sold while the charity is the substantial partner. Otherwise, the donee’s lack of basis tends to reduce the overall tax benefits.
        4. Role of the Charity.
           1. The charity’s role is that of an independent charity looking out for its own best interest. To that end, it will require an appraisal, at a minimum, before selling the limited partnership units. The appraisal may be the same as the donor’s appraisal, although the better practice would be to have an independent review. In addition, the charity may have other procedures it follows, such as review of acceptance and disposition of partnership units by special committees; requirements that it be indemnified against liability and unrelated business income tax before it accepts the units; and “shopping” the units to potentially interested purchasers (e.g. “advertising” the availability of units to the financial community through private communications, notification to the charity’s board, etc.).
           2. Charities are required to disclose the disposition of contributed nonmarketable assets sold within three years of receipt by filing a Form 8282 (Donee Information Return) within 125 days after the disposition. In many instances charities have as policy the retention of nonmarketable assets during the three-year period. If the partnership units are to be retained, then another appraisal will be required at the time of the sale and should be procured by the charity.
           3. An independent charity is best to ensure that the IRS does not conclude that the sale of the units was conducted in other than an arms-length manner. Although private foundations should not be used for this purpose – because of concerns about self-dealing arising not only from the sale of the units but also from the acquisition and retention of the units – supporting organizations may be. Special care should be taken to ensure that all decisions about the retention and sale of the units are made by persons other than the donor or the donor’s family.
        5. Poor Children.
           1. A common concern about the charitable partnership is that the children do not have sufficient assets to purchase the limited partnership units. Generally, it is a concern raised by the charity. Experience suggests that it is not a concern in most family situations. The reason would appear to be that most persons who are ready to contribute significant amounts to charity have already given significant amounts to their descendants or at least in trust for their descendants. However, if that is not the case, or if the costs of generating the funds is prohibitive (e.g., the basis of the purchaser in the assets to be sold to raise cash to purchase the units is zero or very low), then a variation may be used.
           2. The partnership may sell the assets it owns and generate cash. With that cash it may redeem partnership units from the charity, at the appropriately discounted value, thereby, indirectly, increasing the value of the remaining units. To illustrate, suppose donor creates a partnership with 100 general partnership units and 9900 limited partnership units and gives the 100 general partnership units to a trust for the benefit of the donor’s descendants (value is 1 percent of the amount in the partnership; a $1,000,000 partnership produces a $10,000 gift). The trustee, as general partner, orders all of the assets of the partnership to be sold and then negotiates to redeem the charity’s units at appraised value. If the charity’s 9900 limited units are redeemed for $700,000 the partnership has only 100 general partnership units remaining and owns $300,000 in assets. As before, gain will be triggered if the partnership is liquidated. In many instances it may be desirable to retain the form of a general partnership interest in which case a few limited units may be given to the trust or to the donor’s descendants.
           3. Transactions structured in this manner have been advocated across the country by a number of different entities and planners. In certain versions the redemption occurs at deeply discounted values, supported, in some instances, by giving the charity the rights to put the units to the partnership for specified amounts. To illustrate, the partnership might provide for a 50-year term during the first year of which the charity would have the right to put the units for 2 percent of the partnership’s book value, during the second year for 4 percent, and so forth. Planners will need to evaluate such arrangements carefully, particularly given the IRS position with respect to such transactions, discussed below.
     3. IRS Position.
        1. As might be expected, the IRS has identified some potential areas of abuse with charitable family limited partnerships. In 2001, the IRS Exempt Organizations Continuing Professional Education (hereinafter, 2001 EO CPE) identified the “CHAR-FLIP” (an extreme version of the charitable family limited partnership transaction described above) as the “years favorite charity scam.” 2001 EO CPE, p. 128. As provided in 2001 EO CPE, “The charitable family limited partnership technique is touted as avoiding the capital gain tax on the sale of the donor's appreciated assets, allowing the donor to continue to control the assets until some subsequent sale date, often many years in the future, and still provide the donor with a current charitable deduction on his or her income tax return. Another ‘benefit’ is reducing estate taxes.”
        2. 2001 EO CPE describes the CHAR-FLIP as follows:

A typical charitable family limited partnership works as follows: Donor “D”, having substantially appreciated assets, which are often not readily marketable, such as real estate or proprietary interest in a closely held business, sets up a donor family limited partnership (“DFLP”). D transfers highly appreciated assets to DFLP in exchange for both a general and limited partnership interest with the general partnership interest comprising a very modest 1 or 2 percent of the total partnership interests. The DFLP agreement usually provides for a term of 40 to 50 years.

D contributes a large percentage of the DFLP interest to charity “Z”, usually as much as 95 to 98 percent, in the form of a limited partnership interest. D will usually retain the general partnership interest. D may also retain a modest limited partnership interest or transfer such an interest to D’s children. D obtains an independent appraisal of the value of the partnership interests in order to establish the fair market value of the IRC 170(c) charitable contribution deduction. Z receives whatever assets are held by DFLP at the end of the partnership term, assuming the partnership interest was not sold prior to the expiration of the partnership term.

D claims an IRC 170(c) tax deduction based on the value of the gift of the partnership interest to Z. The value likely has been discounted to take into account the lack of Z control and management of partnership operations as well as the lack of marketability of the limited partnership interest in the context of a closely held business.

The key point is control. Control remains with D as the general partner. Z holds a limited partnership interest with no voice in the day to day management or operations of the partnership.

If appreciated property held by DFLP is sold by DFLP, most of the gain escapes taxation by virtue of the IRC 501(c)(3) exempt status of Z. Only the modest limited or general partnership interests held by D and his family are subject to capital gain taxation.

D generally receives a management fee as compensation for operating and managing the partnership.

Z holds a DFLP interest that may produce current income (although many charitable family limited partnerships produce little or no income) as well as an interest in a (hopefully) appreciating asset which will be sold or exchanged no later than the expiration of the partnership term, usually 40 years or even 50 years.

One of the aspects of the “CHAR-FLIP” is a feature which gives a DFLP the right to sell the property to D or his family at a price specified in the partnership agreement. This right is essentially a put option. While such option may serve to benefit Z, the option is often viewed by critics of this technique as working more for the benefit of D or his family than for Z.

* + - 1. Among the identified issues with the foregoing described transaction were private inurement and benefit, unrelated business income under IRC § 511, and excess benefit transaction under IRC § 4958. If the charity is a private foundation, then some additions issues were self-dealing under IRC § 4941, and excess business holdings under IRC § 4943.
      2. Given the issues identified by the IRS, practitioners should consider one or all of the following with charitable family limited partnership planning:
         1. Transfer the GP interest to a family trust contemporaneously or soon after contribution to charity in order to avoid the argument of donor control;
         2. Distribute the net income of the partnership annually;
         3. Allow charity to sell its limited partnership units, if the charity can find a buyer;
         4. Do not grant an option;
         5. Do not sell the partnership property to donor or donor’s family (or trust); and
         6. Do not provide any compensation to or for the benefit of the general partner.

1. CHARITABLE GIFTS OF S CORPORATION STOCK
   1. Before 1998.

Before 1998, a charitable organization could not be a qualified S shareholder. A gift of stock in an S corporation to a section 501(c)(3) charitable organization automatically terminated the S election. Nor could a charitable remainder trust or pooled income fund hold stock in an S corporation. A charitable lead trust could At least 7-years after the contribution of the assets, assuming the assets remain in the partnership and there has been no change in the values, the partnership liquidates charity’s interest (according to its capital account balance) and distributes Asset B ($100 basis and fair market value of $100) to charity. Assume the LLC has a section 754 election in place at the time of the distribution of Asset B.be an S corporation shareholder only if it is a “grantor” trust. Similarly, stock in an S corporation could not be exchanged for a charitable gift annuity without destroying the S election. This problem became more acute after 1986, when the repeal of the *General Utilities* doctrine and changes in corporate and individual tax rates made the use of S corporations even more attractive.

* 1. After 1997.
     1. Rules Broadened. The Small Business Job Protection Act of 1996 permitted charitable organizations to be S shareholders after December 31, 1997. IRC §§ 1361(b)(1(B) and (c)(6).
     2. The Good News. The good news is that it became permissible to make gifts or sales of S corporation stock (a) to charitable organizations, (b) to charitable lead trusts that are grantor trusts or that make an Electing Small Business Trust (“ESBT”) election under IRC § 1361(e), and (c) in exchange for a charitable gift annuity.
     3. The Bad News.

a. Gifts to charitable remainder trusts and pooled income funds are still not permitted. Such trusts cannot be a grantor trust, an ESBT, or a qualified subchapter S trust (“QSST”). A charitable gift annuity is the only real alternative.

b. The donor's charitable deduction is reduced (from the appraised fair market value of the stock) by ordinary income items internal to the S corporation, such as unrealized receivables, appreciated inventory, and depreciation recapture. The rules pertaining to partnership sales and distributions are made applicable to gifts of S corporation stock by the last sentence of IRC § 170(e)(1).

c. The charitable shareholder's entire share of S corporation earnings and gains is automatically treated as unrelated business income subject to the unrelated business income tax, even if the income would otherwise be nontaxable under the usual UBI rules (such as passive dividend, interest, rental, or capital gain income). IRC § 512(e). That is much different from the “look through” rule applicable to partnerships and LLCs. The charitable shareholder will be subject to income tax on its share of S corporation income without regard to actual distributions, if any, from the corporation.

d. Capital gain realized on the sale of the S corporation stock is also taxable as UBI. IRC § 512(e)(1)(B)(ii). There is an exception if all of the stock is sold in a transaction (such as to a public company) that terminates the S election. In that case, the election is deemed terminated on the day before the sale, and because gain on the sale of C corporation stock is not treated as UBI under the usual rules, there is no tax.

e. Note that private foundations often may not hold S corporation stock because of the excess business holdings rules of IRC § 4943.

1. USE OF A SUPPORTING ORGANIZATION TO HOLD S STOCK
   1. Conventional Approach.

Because charitable organizations holding S corporation stock are subject to unrelated business income tax on the organization's share of corporate income and any gains realized on sale, the conventional analysis has been to consider the “best” way to minimize any income taxes. Frequently this analysis involves little more than the consideration of whether it would be better to organize the charity in trust or corporate form. Charitable corporations and charitable trusts are now subject to income tax at roughly the same top bracket, but trusts reach the top bracket much quicker (at taxable income of less than $10,000). However, charitable trusts are entitled to the same maximum rate on capital gain income as individual taxpayers, whereas corporations must pay income tax on capital gain at the usual rates. For these reasons, the conventional wisdom is that a charitable trust is preferable for income tax purposes only if it is expected that the stock will be sold relatively soon. Otherwise, so the conventional wisdom goes, it is usually better to use a corporation.

* 1. Use of a Supporting Organization.
     1. Charitable Corporations. A corporate-form supporting organization could be formed to acquire, hold, and sell S corporation stock. In addition to potential limited liability benefits, the income tax charitable deduction available to tax-exempt corporations receiving unrelated business income can effectively reduce the overall rate of income tax. Under IRC § 512(b)(10), a tax-exempt organization receiving unrelated business income is entitled to a deduction for charitable contributions of up to 10 percent of its unrelated business taxable income. The regulations under this section provide in part as follows:

The contribution, whether made by a trust or other exempt organization, must be paid to another organization to be allowable. For example, a university described in section 501(c)(3) which is exempt from tax and which operates an unrelated business, shall be allowed a deduction, not in excess of 5 percent [now 10 percent] of its unrelated business taxable income, for gifts or contributions to another university described in section 501(c)(3) for educational work but shall not be allowed any deduction for amounts expended in administering its own educational program.

Treas. Reg. § 1.512(b)-1(g)(3).

It is thus possible to reduce the overall unrelated business income tax by having the supporting organization make “upstream” grants to the “parent,” effectively reducing the overall tax rate by about 10 percent.

* + 1. Charitable Trusts. The income tax charitable deduction available to charitable trusts receiving unrelated business income is much different than the rule for charitable corporations. IRC § 512(b)(11) provides as follows:

In the case of any trust described in section 511(b), the deduction allowed by section 170 (relating to charitable etc. contributions and gifts) shall be allowed (whether or not directly connected with the carrying on of the trade or business), and for such purpose a distribution made by the trust to a beneficiary described in section 170 shall be considered as a gift or contribution. The deduction allowed by this paragraph shall be allowed with the limitations prescribed in section 170(b)(1)(A) and (B) determined with reference to the unrelated business taxable income computed without the benefit of this paragraph (in lieu of with reference to adjusted gross income).

Under this section, tax-exempt charitable trusts receiving unrelated business income are entitled to the same income tax charitable deduction afforded individual taxpayers, which in the case of cash gifts to public charities is 50 percent of adjusted gross income. A trust-form supporting organization making “upstream” grants to its charitable “parent” can thus reduce the effective overall tax rate by up to 50 percent.

* + 1. Importance of Cash Flow. Although in most cases it would be preferable to establish a trust-form supporting organization to hold S corporation stock, the best overall strategy will depend on the anticipated cash flow from the S corporation in comparison to the amount of taxable income involved.

1. CHARITABLE GIFTS BY THE BUSINESS ENTITY
   1. Generally.

Although most of us tend to focus on charitable gifts of interests in closely-held businesses, sometimes it makes sense to consider a charitable contribution by the business entity. This can be a particularly effective strategy for gifts of highly appreciated, under productive assets, whether outright to a charitable organization or to a term-of-years charitable remainder trust for the benefit of the business entity. Based on the very broad definition of “person” contained in IRC § 7701(a)(1), the Service has ruled that charitable remainder trusts of this nature may be established by C corporations (PLR 9205031), S corporations (PLR 9340043), or partnerships (PLR 9419021).

* 1. C Corporations.

Unlike the case with individual taxpayers (who generally may deduct charitable contributions up to 30 or 50 percent of adjusted gross income), contributions by C corporations are deductible up to only 10 percent of the corporation's taxable income, computed without regard to certain special deductions for corporations (under IRC §§ 241, 243-247, and 249), any net operating loss carrybacks (under § 172), and any capital loss carrybacks (under § 1212(a)(1)). IRC § 170(b)(2).

* 1. S Corporations.

Prior to the Subchapter S Revision Act of 1982, S corporations were entitled to the same 10 percent charitable deduction allowable to C corporations. See former IRC § 170(b)(2) and 1373(d). It was thus possible for an S corporation shareholder who had already made contributions up to his or her personal limit to make additional contributions up to the corporation's 10 percent limit. After 1982, charitable contributions by S corporations are deductible proportionately by the shareholders. IRC § 1366(a)(1) (which refers to the partnership rules of § 702(a)(4)). The amount deductible (fair market value or basis) is determined at the entity level based on the type of property donated and the status of the donee, and any percentage or other limitations are then determined at the shareholder level based on the shareholder's overall income. Under IRC § 1366(d)(1), however, the shareholder's deduction is limited to the shareholder's basis in the S corporation stock and any corporate indebtedness to the shareholder. An S corporation shareholder owning low basis shares could thus be precluded from deducting his or her entire share of corporate contributions. S corporation shareholders deducting their proportionate share of a corporate charitable gift must reduce their basis in their stock, but only to the extent of the corporation's basis in the property contributed. IRC § 1367(a)(2).

* 1. Partnerships and LLCs.

As in the case of gifts by S corporations, gifts by partnerships or LLCs are deductible proportionately by the partners or members. IRC § 702(a)(4). The amount deductible, however, can be much different. While IRC § 704(d) limits the partner's deduction for the partner's distributive share of partnership loss to the partner's basis, apparently the charitable deduction is not covered by this limitation. As a result, it appears that a partner should be able to deduct his or her entire proportionate share of a partnership gift without regard to basis. The Service has also ruled that a partner deducting his or her proportionate share of a partnership gift must reduce his or her basis in the partnership only to the extent of the partnership's basis in the property contributed. Rev Rul. 96-11, 1996-1 C.B. 140.

* 1. Impact of Section 337.

Corporations making large charitable contributions must be careful not to violate the “new” regulations under IRC § 337, which continue the repeal of the *General Utilities* doctrine. The new regulations (Treas. Reg. § 1.337(d)-4) were generally effective as to transfers of assets occurring after January 28, 1999. Under these regulations, a taxable corporation is required to recognize gain or loss upon the transfer of “all or substantially all of its assets to one or more tax-exempt entities.” Treas. Reg. § 1.337(d)-4(a)(1). With certain exceptions, the rule also applies in the event of “a taxable corporation's change in status to a tax-exempt entity.” Treas. Reg. § 1.337(d)-4(a)(2). It specifically applies to transfers both to tax-exempt organizations and charitable remainder trusts. Treas. Reg. § 1.337(d)-4(c)(2). The determination of whether a corporation has transferred “substantially all” its assets is based on all the facts and circumstances under the general rules of IRC § 368(a)(1)(C). The Courts generally have considered a variety of factors in determining whether a corporation has transferred substantially all its assets, such as the percentage of assets transferred, the types of assets retained, the purpose for the retention of assets, and the liabilities of the corporation prior to the transfer.

* 1. Contributions to Charitable Remainder Trusts.

Creation of a charitable remainder trust by a business entity can enable sale of contributed appreciated assets with no capital gains cost. An illustrative ruling is Private Letter Ruling 200644013. In that ruling, an S corporation proposed to contribute appreciated real property to a 20-year term charitable remainder unitrust. The Service ruled that there would be no built-in gain recognition upon either the contribution to the trust or the trust's sale of the property within the 10-year recognition period.

* 1. Contribution of Intellectual Property to Private Foundation.

In PLR 200715015, a corporation formed a limited partnership and contributed to the partnership exclusive ownership of certain trademarks and other intellectual property. The other partner was the owner of the corporation who contributed cash. The partnership granted the corporation a license to use that property in exchange for a royalty based on the corporation’s net sales. The corporation then contributed the limited partnership units to a private foundation (created and managed by the owner). Because the limited partnership would receive 95 percent or more of its gross income from passive sources (here, royalties), the units would not constitute an excess business holding. Further, the foundation would have no unrelated business income because royalties are exempt.

1. SELECTED MUSINGS ON CHARITABLE LEAD ANNUITY TRUSTS

A**.** Charitable Lead Trust as S Corporation Shareholder**.**

1. Qualification as ESBT. A charitable lead trust can qualify as an ESBT under IRC § 1361(e). The only “potential current beneficiaries” are charitable organizations, which is expressly permitted under section 1361(e)(1)(A)(i)(III), and it is not an ineligible tax-exempt trust or QSST under section 1361(e)(1)(B).

2. No Charitable Deduction. The CLT will not be allowed any deduction for its payments of the charitable annuity or unitrust amount except with regard to income from other than S corporation stock. IRC § 641(c)(2)(C). Section 1366(a)(1)(A) does not apply. It merely passes through to the ESBT the deductions which would have been allowable to the S corporation were it a true taxpayer. See Treas. Reg. § 1.641(c)-1(d). This includes the charitable deduction, but only for amounts paid to charity by the S corporation. It does not create a deduction for amounts paid to charity by the trust itself. The ESBT can reduce the tax it owes as a result of the amount paid to charity by the S corporation, but it gets no tax benefit from payment of the charitable annuity or unitrust amount. This conclusion is both confirmed and restricted by the regulations. First, the donation by the S corporation must have been made from gross income. This imposes on the S corporation a requirement normally applicable only to trusts, and one to which it may not wish to adhere because it does not have any meaning to its individual shareholders. Consider the effect of a donation by the corporation of land held by it. The land is usually not part of gross income, so the deduction allowed to individual shareholders will not be allowed to the ESBT. Treas. Reg. §1.641(c)-1(d)(2)(ii). The donation is treated as made pursuant to the governing instrument of the ESBT. To the extent the S corporation made the distribution from gross income, it may still be limited by the UBI rules of IRC § 681. These rules are likely to apply to most operating businesses operated as S corporations, except perhaps certain real estate rental businesses.

3. Effect. This result sounds terrible, butit is conceptually no worse than the situation for a CLT holding stock in a C corporation. It is true that the CLT pays tax on its share of the corporation’s total income whether or not it is distributed, and then makes the required charitable distribution, but compare these two examples (which for purposes of simplicity assume that the top individual and corporate rates are both 40 percent):

C Corporation Example.

$1 million CLAT.

$70,000 annuity.

Corporation earns $200,000.

Corporation pays tax of $80,000.

Corporation distributes $70,000 to CLAT.

CLAT distributes $70,000 to charitable beneficiary.

CLAT deducts $70,000 per IRC § 642(c).

CLAT’s taxable income and tax are both $0.

S Corporation Example.

$1 million CLAT.

$70,000 annuity.

Corporation earns $200,000.

Corporation pays no tax.

Corporation distributes $150,000 to CLAT.

CLAT pays tax of $80,000 (40 percent of $200,000).

CLAT distributes its remaining cash flow of $70,000 to charitable beneficiary.

Comparison. Both results are substantively the same. If the S corporation distributed less of its earnings, a cash flow crunch would result, but the same is true in the C corporation example. In only one respect is the ESBT CLAT situation clearly worse than for the situation for the C corporation CLAT. This occurs where there are sales or deemed sales of the ESBT stock. A deemed sale might occur if some of the stock were distributed to the charity as part of an annuity or unitrust amount distribution. If C corporation stock were sold and distributed (or simply distributed to the charity), the CLAT would recognize capital gains, but would usually get an offsetting charitable deduction. In the ESBT situation, the gain is recognized but there is no offsetting deduction.

B. Funding the Family Foundation from a Charitable Lead Trust.

1. Generally. A family that has sufficient wealth to create a family foundation may well consider using one or more charitable lead trusts to minimize transfer taxes on large transfers to younger generations. By directing the ongoing charitable distributions to a family foundation, the tax-saving characteristics of the lead trust are obtained, and the amounts distributed are paid to the family foundation, and family members are able to influence, if not control, the ultimate application of the funds.

2. Minimum Distribution Requirement. Treas. Reg. § 53.4942(a)-2(c)(2)(iii) takes the position that a private foundation that is the beneficiary of a charitable lead trust must take into account, as part of the foundation’s minimum distribution, the lesser of (a) the income distributions from the lead trust or (b) five percent of the trust assets. However, this regulation was held invalid in Ann Jackson Family Foundation v. Commissioner 15 F.3d 917 (9th Cir. 1994), aff’g 97 T.C. 534 (1991) (reviewed), in which a private foundation disregarded the annuity distributions received from the trust in determining its minimum investment return. In response, the Service intends to issue proposed regulations modifying the regulations under section 4942. Until further guidance, income distributions received by a private foundation from a non-grantor charitable lead trust will not be included in determining a private foundation’s distributable amount for the year the amount is received. Notice 2004-36, C.B. 2004-19 at 889. See also Notice 2004-35, C.B. 2004-19 at 889.

3. Estate Tax Problem in Grantor's Estate. Charitable lead trusts that make payments to a foundation in which the grantor of the trust has an influential role can be problematic. In Revenue Ruling 72-552, the Service held that the value of property transferred to a foundation was included in the donor’s gross estate under section 2036 because the donor/decedent, in his capacity as a member, director, and president of the foundation, had the power to direct the disposition of its funds for charitable purposes. Similarly, in Private Letter Ruling 7929002 the same rule was applied to a decedent who held multiple fiduciary positions in an organization to which the income from a trust he had created was paid. In Rifkind v. U.S., 5 Cl. Ct. 362 (1984), a foundation was the sole beneficiary of a lead trust, and its settlor (as an officer, member, and director of the foundation), was able to designate (or at least participate in designating) the recipients of foundation grants. The court found IRC § 2036(a)(2) applicable, and held that the assets of the trust were included in the grantor's estate.

4. Solution to Estate Tax Problem. Inclusion in the grantor's taxable estate can be avoided by providing that distributions from the lead trust to the foundation will be segregated into a separate account over which the grantor has no control. In Private Letter Ruling 200138018, for example, the grantor of a lead trust with a private foundation beneficiary was also a member of the foundation's board of directors. The bylaws of the foundation provided that distributions from a trust created by an officer or director would be held in a separate account administered and distributed solely by a separate fund committee that did not include the grantor, and over which the grantor had no power or control. The Service held that, because the grantor would not be permitted to vote on matters relating to the disbursement or grant of funds received from the lead trust, the trust assets would not be include in the grantor's estate.

C. Funding a Lead Trust with a Promissory Note.

1. Promissory Notes in Estate Planning. Many estate planning transactions exist that involve promissory notes that will be included in a client’s estate. For example, a business may be sold to a grantor trust during the client’s lifetime in exchange for a promissory note, which will be included in the client’s estate at his or her death. A variant is for the client to establish a trust during the client's lifetime and arrange for that trust to have an option to purchase business or other assets from the client’s estate. The assets in the client’s estate receive a new income tax basis under IRC § 1014. So long as the option is exercised when the value of the asset is the same as the value in the estate, that purchase will not result in any capital gains tax.

2. Use of Lead Trust. The note received in these cases may be distributed by the client’s estate to a charitable lead trust. If the lead trust payments are the same, or approximately the same, as the interest payments on the note, then no income tax is paid on the note payments. The purchased interests can be managed, recapitalized, sold, etc. within the trust. If the note has a small amortization with almost all the principal paid at the end, a profitable business will produce extraordinary results. The risk in the transaction is that by waiting until death, the IRC § 7520 rate is unknown and unknowable, and the business may increase in value. A current sale that is paid off prior to the grantor’s death may hedge this risk.

3. PLR 200124029. Private Letter Ruling 200124029 confirmed that a lead trust may be funded with a grantor's note without causing self-dealing. A personal representative requested rulings with respect to the eventual funding of a series of charitable lead annuity trusts. A significant portion of the decedent’s estate was comprised of interests in real estate and various real estate partnerships and corporations (the “Real Estate”). Under the terms of the decedent’s will, his entire estate passed to a QTIP marital trust for the decedent's wife. The personal representatives divided the marital trust into three trusts, each with identical terms. Upon the death of the wife, the marital trusts would be divided among trusts for the benefit of the decedent’s descendants and several CLATs. Each CLAT had a 21 year term and would be designed to pay the smallest annuity rate that would result in a zeroed-out remainder interest and full estate tax charitable deduction.

The personal representatives proposed to sell the Real Estate to a newly formed limited liability company which would be owned by the decedent’s children and grandchildren, in exchange for a secured, interest-bearing promissory note. The note would (a) bear interest at the applicable federal rate in effect for the month in which the sale occurs, (b) have a term of not greater than thirty years, and (c) be secured by the Real Estate. The fair market value of the note would be equal to the fair market value of the Real Estate as established by a qualified appraisal. After the transaction, the note would be included among the assets used to fund the QTIP marital trusts. Upon the death of the wife, the note would be included among the assets used to fund the CLATs. As a result, the children would be indebted to the CLATs.

By entering into the transaction, it was expected the CLATs would be protected from fluctuations in the real estate market that may occur prior to the death of the decedent’s wife. The note would serve to fix the value of the CLATs’ assets at the current value of the Real Estate, thus protecting the CLATs from a downturn in the real estate market, and would fix the return of the CLATs through a fixed rate of interest, thus protecting the CLATs from fluctuations in the returns realized by the Real Estate itself. Also, as a result of the proposed transaction, the cash flow of the CLATs would be improved and stabilized so that the CLATs will be better able to satisfy their annuity obligations. Without the sale, the CLATs would receive the Real Estate and would be required to engage in the real estate business. With the proposed transaction, the CLATs and thus the charitable beneficiaries would be less concerned about fluctuations in the real estate market.

Possibly most important, without the proposed transaction, the CLATs only would have access to the Real Estate in order to satisfy annuity payments to the charitable beneficiaries. With the proposed transaction, the CLATs would have access to (a) the notes, (b) the Real Estate, and (c) the capital of the family LLC.

The Service ruled that, under the probate exception to self-dealing under Treas. Reg. § 53.4941(d)-1(b)(3), the sale to the new LLC owned by the decedent's children and grandchildren, the eventual holding of the notes by the CLATs and the payments from the LLC, and the continued operation of the Real Estate by the LLC would not constitute self-dealing.

4. Remember That a Lead Trust is Taxable. A CLT receives an income tax deduction for amounts distributed to charity but if a lead trust owns an asset that is sold any additional capital gain will be taxed to the trust, unless the lead trust is a grantor lead trust.

D. Lead Trust's Investment in a Limited Partnership was not Self-Dealing.

Private Letter Ruling 200018062 involved the transfer of real estate and interests in a limited partnership to a nine-year testamentary charitable lead unitrust created upon the death of the grantor’s surviving spouse. The other limited partners of the limited partnership were a number of individuals and trusts, an estate, and another limited partnership. The individuals were all related to the grantor of the CLUT by blood or marriage. All of the trusts were for the benefit of those individuals. The partnership had a corporate general partner. Real estate transferred to the CLUT would be sold and the proceeds reinvested in additional interests in the partnership, but the CLUT would always own less than 20 percent of the value of the total partnership interests. The partnership charged its limited partners a fee for its investment services, including compensation to an unrelated professional investment manager and reimbursements to the corporate general partner. Another corporation provided accounting, tax, and clerical services on a cost-sharing basis to members of the family and various family entities, including the CLUT and the partnership. The CLUT and the partnership paid a fee for these services. The service corporation subleased office space to the partnership. The partnership, both corporations, and many of the limited partners were disqualified persons with respect to the CLUT. The Services held that none of these activities would constitute self-dealing:

The CLT’s retention of an interest and investment in the partnership are not direct or indirect acts of self-dealing, as defined in section 4941(d)(1).

Payments by the CLT to the service corporation for general accounting, tax and clerical services and to the partnership (i) for investment management and advisory services, (ii) for the reimbursement of the corporate general partner for costs and expenses paid as the general partner, and (iii) for the payment to the service corporation for general accounting, tax and clerical services do not constitute direct or indirect acts of self-dealing by the CLT, as defined in section 4941(d)(1), or taxable expenditures, as defined in section 4945(d)(5).

A sublease of office space by the partnership from the service corporations does not constitute an indirect act of self-dealing by the CLT, as defined in section 4941(d)(1).

E. Modification of a Successful CLT can be Permissible**.**

1. Early Termination.

Private Letter Ruling 199952093 involved a twenty year inter-vivos charitable lead annuity trust. The sole charitable beneficiary was the grantor’s family private foundation. Originally the CLT was funded with shares of stock in a closely-held, non-public bank holding company which was controlled by the grantor’s family. The CLT was designed to pay the private foundation a qualified annuity equal to 5 percent of the fair market value of the stock contributed to the CLT. At the end of the charitable term the remaining trust assets would be distributed to the grantor’s four children who also are all of the trustees of the CLT and all of the foundation managers of the private foundation.

The bank holding company merged into a public corporation whose common stock is traded on the New York Stock Exchange. The CLT received a number of shares of stock in the new company with a value substantially in excess of the value of the stock originally contributed to the CLT. Also, the dividend the CLT would receive from the new company would be well in excess of the amount necessary to pay the annuity to the family foundation.

Since the CLT now had assets that were readily convertible to cash, the CLT’s charitable interest could be satisfied much earlier than originally anticipated by the grantor. Accordingly, the grantor, the trustees of the CLT, the foundation managers of the family foundation, and the four remainder beneficiaries all wished to pay to the CLT, in one lump sum, the remaining amount due to the CLT, without discount.

The parties filed a petition in state court seeking authorization to pre-pay the CLT and then to terminate the trust by distribution of the remainder interests. Their petition named the state Attorney General as a party to the suit to protect the interests of the charity.

Under these facts the IRS ruled as follows:

The Trustees’ prepayment of the entire remaining charitable interest without discount to the family foundation as the sole charitable beneficiary of CLT would not constitute the termination of a private foundation under section 507 of the Code.

The Trustees’ prepayment of the entire remaining charitable interest without discount to the family foundation as the sole charitable beneficiary of the CLT would not be an act of self-dealing under section 4941 of the Code since the family foundation was not a disqualified person.

The Trustees’ prepayment of the entire remaining charitable interest without discount to the family foundation would not be a taxable expenditure under section 4945 of the Code but the IRS cautioned that this is not to say that the income payment to the charitable beneficiary of a charitable lead trust will never constitute a taxable expenditure. Here, however, the payment was to be made for the appropriate charitable purpose established by the trust document so there would be no taxable expenditure and it was understood that neither the CLT, the grantor, the trustees, nor any “disqualified person” within the meaning of section 4946 of the Code would receive any benefit from the prepayment to the family foundation other than the rights of remaindermen provided in the trust document. The Service ruled favorably on similar facts in PLR 200225045.

2. Term Extension Coupled with Early Distribution.

Private Letter Ruling 200226045 involved another successful lead trust plan. The trustees of a charitable lead annuity trust proposed to modify the terms of a lead trust such that the trust’s charitable beneficiary, a private foundation, and the remainder beneficiary, a non-exempt limited partnership, would receive different distributions than under the original agreement. The CLT had an initial term of 15 years, of which 11 years remained. Due to appreciation in the value of the trust assets, the value of the assets greatly exceeded the amount needed to fund the remaining annuity obligation to the charitable beneficiary.

The trustees executed an amended and restated agreement providing that the CLT would distribute all the trust assets in excess of 110 percent of the remaining undiscounted annuity obligations to the limited partnership. The remaining undiscounted annuity obligation would be paid in annual annuity installments over a new fifteen year term, based on the annuity factor determined in accordance with the applicable regulations and the section 7520 rate applicable to the date of the amendment, such that the remainder interest would be as close to zero as possible.

The amendment required the CLT to obtain a ruling from the Internal Revenue Service that the distribution to the remainder beneficiaries would not violate any of the restrictions on private foundations in IRC §§ 4941 through 4945. In addition, the parties planned to petition the state court to approve the amendments to the CLT, and to make the state Attorney General a party to the proceedings.

The Service ruled that the CLT’s distribution of excess assets to the limited partnership, and the payment of the remaining undiscounted annuity obligation to the charity at a new annuity amount based on the current IRC § 7520 rate for a new 15 year period would:

Not constitute a termination of a private foundation under section 507 because section 53.4947-1(e)1 of the regulations specifically provides that the provisions of section 507(a) do not apply to a trust described in section 4947(a)(2) by reason of any payment that is directed by the terms of the governing instrument of the trust and is not discretionary with the trustee. The trust agreement directed the terms of the payments to the charity and was not discretionary with the trustees.

Not be self-dealing under section 4941 because the CLT, treated as a private foundation described in section 501(c)(3) of the Code, was not a disqualified person with respect to the charity. Thus, the CLT’s payment of the remaining undiscounted annuity obligation to the charity would not be an act of self-dealing. There would be no sale or exchange of property, the charity was merely agreeing to receive more money.

Not subject the CLT to tax on the undistributed income of a private foundation under section 4942 because the CLT already was subject to a payout requirement. Although the CLT’s payout requirement would change, the change was required by the amended agreement that was to be approved by court order and the state Attorney General.

Not subject the CLT to tax on excess business holdings under section 4943 because the payments to the limited partnership and the charity would not result in the CLT acquiring interests in business.

Not be an investment which jeopardizes charitable purposes under section 4944 because the payment of the remaining annuities would be made to accomplish charitable purposes. Moreover, the transaction would be based on the amended trust agreement approved by a court order and in a court action in which the state Attorney General is joined to protect the interest of the charity. The charity would be protected from decline in the value of the CLT’s assets by the fact that the undiscounted amount of the remaining annuities to the charity plus 10 percent would remain in the CLT. There was no investment, the CLT is merely paying its obligations.

Not be a taxable expenditure under section 4945 since the CLT’s expenditure to the charity as required under the CLT’s trust instrument was in furtherance of a section 170(c)(2)(B) purpose in fulfillment of its charitable lead annuity requirement in its governing instrument.

F. Back-Loaded Charitable Lead Annuity Trusts – Shark-Fin CLATs**.**

1. Generally. The charitable lead annuity trust regulations allow an annuity amount that is initially stated as a fixed dollar or fixed percentage amount to increase during the annuity period, provided that the value of the annuity amount is ascertainable at the time the trust is funded. The regulations also state that the annuity amount “may be changed by a specified amount” at the expiration of a term of years or at the death of an individual. Treas. Reg. §§ 1.170A-6(c)(2)(i)(A), 20.2055-2(e)(vi)(a), and 25.2522(c)-3(c)(2)(vi)(a).

In Revenue Procedures 2008-45 and 2008-46, the Service issued sample inter vivos and testamentary charitable lead trust forms and annotations. The forms do not impose any particular requirements on the annuity payout schedule, and thus allow a CLAT to be constructed with back-loaded payments. In Private Letter Ruling 201216045, the Service ruled that a testamentary CLAT could make variable, ascending (by 20 percent per year) annuity payments to the CLAT’s charitable income beneficiary over its 10-year term without violating any of the requirements applicable to CLATs under the income, estate, or excise tax provisions of the Internal Revenue Code.

2. Benefits. A traditionally structured CLAT may fail if the growth rate of the assets does not exceed the section 7520 rate; even if the growth rate does exceed the section 7520 rate, the CLAT may fail because of the “path of the returns.” Back-loading the payment to charity is intended to hedge against market volatility, thereby allowing for a significant buildup of funds ultimately passing to family members on the termination of the trust. Recall, as well, that the basic economics of a CLAT are that all appreciation in excess of the section 7520 rate passes to the grantor’s non-charitable beneficiaries (typically children). Thus, the longer that assets are projected to remain in the CLAT, the more appreciation will accumulate. Further, if a note with a balloon payment is used, the timing of payments may match up perfectly with the back-loaded CLAT payments.

3. Illustration. To illustrate, assume a section 7520 rate of 2.0 percent. A trust funded with $1,000,000 that pays $1,000 per year for 19 years to charity, followed by a payment at the end of the 20th year of $1,462,651, would result in no noncharitable gift. With an overall annualized yield on the CLAT assets over the 20-year trust term of 4.7 percent, the original $1,000,000 would remain in the trust at the end of the term. If the rate of return were 7 percent, then almost $2,400,000 would remain in the trust.

Longer periods will yield more spectacular results. For example, a 40-year trust funded with $1,000,000 might need to pay $2,149,000 in the 40th year, in addition to $1,000 payments in each of the first 39 years. Such a trust that grew at 4.7 percent would have $4,000,000 remaining after all payments were made, and $12,600,000 if the growth rate were 7 percent.

In general, the consequences of such long terms may be unpredictable. Suppose a charity with the right to receive $1,000 per year for 40 years and $2,149,000 in year 40 were approached by a buyer acting independently of the original donor, to conduct an arms-length negotiation and potential transaction. If such a charity were conservative and anticipated earning only 5 percent per year, on average, over the 40-year term, such a charity might consider selling its annuity interest for $306,000 plus a reasonable profit. Might the remainder beneficiaries of such a trust be interested in purchasing the annuity interest for something in the range of $400,000? If so, the charity might be hard-pressed to refuse to sell the annuity stream, because $400,000 today earning 5 percent over 40 years would be worth approximately $2,800,000, versus the $2,149,000 the charity would receive in 40 years (assuming the trust is not so poorly invested that it underperforms).

For a further discussion of shark-fin CLATs, see Lee, Hall, and Berry, *Innovative CLAT Structures: Providing Economic Efficiencies to a Wealth Transfer Workhorse,* 37 ACTEC L. J., Summer 2011, at 93.