THE CATHOLIC FOUNDATION

The Good Advisor

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Charitable Gifts of FLP, LLC & S Corporation Interests

Many successful individuals who seek to make substantial gifts to charities have their primary wealth in interests of closely held businesses. The charitable gift of an interest in a closely held business involves some unique issues and creates – if properly understood and planned – exciting opportunities for a philanthropically minded client. This issue focuses on charitable gifts of interests in Family Limited Partnerships, Limited Liability Companies and S Corporations.

I. FAMILY LIMITED PARTNERSHIPS

A Family Limited Partnership (FLP) is a limited partnership in which the interests are held solely by family members. It melds the tax treatment afforded family partnerships under IRC Sec. 704(e) with that permitted to holders of limited partnership interests under the Uniform Limited Partnership Act.

By selecting partnership tax treatment, the FLP will be treated as a flow-through entity. Income items, deductions, and credits flow through to the partners pro-rata to be reported by the partners on their personal tax returns.

FLP distributions are generally tax free, with some exceptions. For example, distributions of cash or marketable securities in excess of a partner's basis in the partnership may trigger income tax liability.

Charitable Gifts by an FLP and Charitable Gifts of an FLP Interest

A charitable gift by an FLP will cause a flow-through of the charitable deduction to the partners, who can each take their pro-rata share of the deduction on their individual income tax returns. This deduction is not normally limited by the partner's basis in the partnership.

Alternately, a partner may take distributed property from the partnership and in turn donate such property to a charity. The basis and holding period of this property will usually be the same in the hands of the partner as it was for the partnership. Special rules, though, may apply to cash and marketable securities.

For a charitable gift of an FLP interest itself, a holding period in excess of one year in the hands of the donor will be necessary for the donor to deduct the full fair market value (FMV) of the partnership interest.

However, the presence of debt undertaken by the partner to acquire the partnership interest, or by the partnership to support partnership investments, may bring bargain-sale rules into play, with partition of basis into gift and sale portions. This could discourage the donation of leveraged interests.

Furthermore, there is a risk of unrelated business taxable income (UBTI) when an FLP interest is given to charity [IRC Sec. 512(c)]. In the case of a transfer to a charitable remainder trust the consequences could be even more severe: In Leila G. Newhall Unitrust, 104 TC 236, 105 F3d 482 (1995), the court held that if the charitable remainder trust owns an interest in an LLC or partnership, items considered UBTI could pass from the partnership or LLC to the charity. Before passage of the Tax Relief and Health Care Act of 2006, the incidence of any UBTI would compromise the tax-exempt nature of the charitable remainder trust. Under current law, there is no automatic loss of the tax-exempt status, but there is a painful excise tax imposed equal to 100% of the UBTI amount.

II. LIMITED LIABILITY COMPANIES

A Limited Liability Company (LLC) offers the tax advantages of a partnership along with much of the limited liability protection afforded to shareholders in a corporation. Unlike a basic FLP, no one need be in the comparable position of a general partner exposed to unlimited liability.

LLC interest holders are generally referred to as "members," their enterprise is governed by "Articles of Organization," and overall guidance is provided by a "manager" or "managers." A number of LLCs are converted partnerships which sought greater protection from liability.

Charitable gifts of an interest in an LLC will typically be treated for tax purposes as are those of a partnership interest. The same potential issues with respect to debt, capital accounts, and holding periods need to be considered.

III. S CORPORATIONS

An S corporation is similar to a partnership in that both are tax conduits. The character of items of income, deductions, losses and credits passes through to the shareholders. Although an S corporation does not usually pay a tax, it must file an annual return on Form 1120S.

Before a corporation can become an S corporation, it must meet several requirements (including, but not limited to):

- It must be a domestic corporation
- It must have 100 or fewer shareholders
- The shareholders must all be individuals, estates, certain types of trusts, qualified retirement plans, and charitable organizations exempt from income tax under IRC Sec. 501(a)
- There must be only one class of stock issued and outstanding. A corporation with, for example, both common and preferred stock would not be eligible.

Note that a charitable remainder trust cannot be an S corporation shareholder because these trusts are not qualified exempt organizations under IRC Sec. 501(c)(3), but, rather, obtain their tax exempt status under IRC Sec. 664.

Unlike partnership owners, donors of S corporation shares to charities may deduct such contributions only to the extent of their basis in the S shares.

IV. WHO SHOULD DONATE – THE ENTITY OR THE SHAREHOLDER?

From a tax perspective, it may be more advantageous for the entity to be the donor than it is for the controlling shareholder to donate as an individual.

Important Note on Contributions by S Corporations

The Pension Protection Act of 2006 included a temporary provision that favored the donation of appreciated property by S corporations by amending IRC Sec. 1367(a)(2) for charitable contributions made after December 31, 2005 and before December 31, 2007. The provision provides that this basis limitation does not apply to a contribution of appreciated property to the extent the shareholder's pro rata share of the contribution exceeds the shareholder's pro rata share of the adjusted basis of the property. Thus, the basis limitation of IRC Sec. 1366(d) does not apply to the amount of deductible appreciation in the contributed property.

For example, assume that in taxable year 2007, an S corporation with one shareholder makes a charitable contribution of a capital asset held more than one year with an adjusted basis of $200 and a fair market value of $500. Assume the shareholder's adjusted basis of the stock (as determined under IRC Sec. 1366(d)(1)(A)) is $300. For purposes of applying this limitation to the contribution, the limitation does not apply to the $300 of appreciation and since the $300 adjusted basis of the stock exceeds the $200 adjusted basis of the contributed property, the limitation does not apply at all to the contribution. Thus, the shareholder is treated as making a $500 charitable contribution. The shareholder reduces the basis of the S corporation stock by $200 to $100 (pursuant to IRC Sec. 1367(a)(2)). See also Rev. Rul. 2008-16; 2008-11IRB 1.

Note that President Bush has requested the extension of this provision in the 2008 Budget.

How do you compare the tax effect of an entity versus an individual donation? Multiply the FMV of the donated property by the applicable tax rate to obtain the tax savings from the contribution deduction. To this add the value of the capital gain tax avoided. If the total is then subtracted from the FMV of the donated property, the remainder will be the after-tax cost of the gift.

An additional factor to consider is the tax consequence for the charity. While a typical contribution of an appreciated interest in a partnership or LLC will not generate tax liability for the charity, a similar contribution of an interest in an S corporation will lead to taxation of the appreciated portion of the gifted interest as UBTI. The net result for the charity will thus be less favorable.

V. VALUATION OF FLP, LLC OR S CORPORATION INTERESTS

For purposes of valuing a gift of an FLP, LLC, or S Corporation interest, there is a difference whether the donor makes the gift to a public charity or private foundation. A gift of appreciated property held in the long-term to a public charity is valued at the fair market value. The same gift to a private foundation would need to be reduced by the amount of gain that would have been long-term capital gain [IRC Sec.170 (e)(1)(B)(ii)]. (There is an exception to this provision for gifts of "qualified appreciated stock" – but the definition of qualified appreciated stock refers to stock that is publicly traded.) Because of the valuation limits, the contribution of a closely held business interest to a private foundation would likely not be a good strategy.

The valuation of an FLP, LLC, or S Corporation interest will require a qualified appraisal. Recall that the Pension Protection Act of 2006 created stricter rules for completing the appraisal with more severe penalties for overvaluation as well.

Being Careful with FLP Formation

Over the past decade, the IRS has contested FLPs in private letter rulings and in court. The FLP cases that especially trouble the IRS are so-called "deathbed FLPs", excessive or unsubstantiated FLP valuation reductions, FLPs without any reasonable independent business purpose, and FLPs that fail to adhere to the appropriate formalities. That being the case, adherence to the appropriate organizational and operational formalities of the FLP is vital and should be demanded both by donors and by recipient charities.

VI. PROTECTING THE CHARITABLE DONEE

Charities which receive donations of limited partnership interests may be liable for the acts of the general partners or of the partnership itself, but only up to the value of their interest in the partnership, provided that the partnership agreement has been properly drawn and that no conduct occurs which permits "piercing the veil."

Other concerns for the charity include the possibility of "phantom income." This means that tax liability for income may not be coincident with a cash distribution from the business with which to pay the taxes due. Thus, a negative cash flow for the charity may result at times.

Interests in LLCs and S corporations which are properly constituted and properly operated should cause no liability problems, although such interests may be illiquid and difficult to market.

VII. OTHER ISSUES

Charitable gifts of interests in closely held entities are clearly complex and tax-sensitive transactions. Both donors and charities should plan carefully prior to consummating such gifts.

Some additional cautionary points:

- Transfers of 50 percent or more of a partnership during one year may lead to a technical termination of the partnership
- A donation of debt-financed property may produce UBTI for the recipient charity
- A disposition of low-basis S corporation shares by a charity (which stands in the shoes of the donor with regard to basis) could lead to substantial tax liability, since gains will taxed as UBTI
- A donation of an interest in a closely held entity to pooled income funds or charitable remainder trusts are fraught with potential dangers and should be planned with extra care
- No charitable gift of shares in a closely held enterprise should require redemption as a condition of the gift
- A donation of Section 306 shares, or of shares in a "collapsible corporation" may result in lower than FMV contributions since the value of such contributions must be reduced by the amount of ordinary income that would have been realized by the donor upon their sale
- A donation of a successor or remainder interest in an LLC that owns real estate subject to a long-term lease may create problems. The IRS and Treasury released Notice 2007-72 to indicate their growing interest in a transfer that generates an excessive deduction (especially when compared to the price the donor paid for the interest).

Interim Guidance on the 2% Deduction Floor for Investment Advisory Fees

In Michael J. Knight, Trustee of William L. Rudkin Testamentary Trust v. Commissioner, 552 U.S. ___, 128 S. Ct. 782 (2008), the Supreme Court held that costs paid to an investment advisor by a trust or estate generally are categorized under the 2% floor for miscellaneous itemized deductions under IRC Sec. 67. This decides (for now) the question of whether an exception can be made for fees "paid or incurred in connection with the administration of the estate or trust which would not have been incurred if the property were not held in such estate or trust." In response to the ruling, the IRS and Treasury will issue final regulations under Reg. 1.67-4. Until that time, taxpayers will not be required to determine the portion of a bundled fiduciary fee that may be subject to the 2% floor under Sec. 67 for any taxable year before 2008. Instead, the taxpayers may deduct the full amount of such fees.

Source: Notice 2008-32; 2008-11 IRB 1

Change in the Rule Concerning the Valuation of Subsequent Contributions of a Fractional Interest of Tangible Personal Property

The Pension Protection Act of 2006 significantly changed the rules governing charitable gifts of a fractional interest in tangible personal property. One rule limited the valuation of a gift made after the initial fractional interest gift. The deduction for income, gift and estate tax purposes was limited to the lesser of fair market value on the date of the gift, or value set at the time of the original gift. If the property appreciated over time, the donor would not benefit from the increase in value for his subsequent gifts.

This rule could be a real problem in the event the donor had died and his estate was forced to make a gift of the remaining interest in the tangible personal property to the charity. This donation was based on the value set at the time of the original gift, but the interest itself would be valued at fair market value for estate tax purposes.

However, under the Tax Technical Corrections Act of 2007, Congress changed the rule again so that the valuation of the donation of a fractional interest in the tangible personal property will be solely the fair market value of that interest at the time the gift is made.

Source: Tax Technical Corrections Act of 2007, Section 3(d)

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