THE CATHOLIC FOUNDATION

FALL 2013 VOLUME XXV ISSUE IV

THE Good Advisor

Planning for Gifts of Business Interests

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"Genius," he said, "is 1% inspiration and 99% perspiration."[1]

A donor planning a charitable gift of an interest in a business entity might say something similar. The idea only makes up about one percent of the gift's success. To make it truly serve the needs of both donor and charity requires employing Edison's work ethic and suffering the perspiration of proper planning. A charitable gift of an interest in a business entity can offer many advantages over a cash gift, but only if properly planned and executed. A poorly planned or incorrectly executed gift can result in a lost charitable tax deduction for the donor and/or taxation to the charity.

This issue of *Techniques* provides an overview of this rewarding but complex and tax-sensitive area of practice, including the basics of charitable gifts of interests in family limited partnerships (FLPs), limited liability companies (LLCs) and S corporations, and an examination of some of the potential benefits and problems for both donors and charities.

GENERAL OBSERVATIONS ON CHARITABLE GIFTS OF INTERESTS IN FLPS, LLCS AND S CORPORATIONS

The donation of a gift of a business interest first requires the donor to value the interest in the business entity. In this regard, it is essential to thoroughly understand the valuation rules of the Internal Revenue Code (IRC). Generally, a business property interest owned by the donor for longer than one year is valued at its "fair market value" (FMV)—the price at which the property would change hands between a willing buyer and a willing seller, neither being under a compulsion to buy or to sell and both having reasonable knowledge of the relevant facts.[2]

In order for the donor to claim a charitable deduction for donations valued in excess of $250, the charity must acknowledge, *contemporaneously with the gift and in writing*, the following information:

- The amount of a cash donation or a description of any non-cash property donated
- A statement of any goods or services the charity provides in consideration, in whole or part, for any cash or other property donated, including a description and good faith estimate of the value of such goods or services, and
- A statement, if applicable, of whether the charity provides any intangible religious benefits.[3]

If the value of the gift is more than $500 and less than $5,000, the written acknowledgement must also contain the following items:

- The manner and approximate date of acquisition of the property or, if the property was created or produced by the donor, the approximate date of substantial completion, and
- The adjusted basis of the property held by the donor for less than 12 months immediately preceding the date of the gift and, when the information is available, the adjusted basis of the property held for 12 months or more.[4]

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- The adjusted basis of the property held by the donor for less than 12 months immediately preceding the date of the gift and, when the information is available, the adjusted basis of the property held for 12 months or more.[4]

For non-cash donations of $5,000 or greater, the donor must obtain a "qualified appraisal" by a "qualified appraiser" as described under IRC § 170(f)(11)(E). These guidelines will be considered satisfied if the appraisal is consistent with the substance and principles of the Uniform Standards of Professional Appraisal Practice as developed by the Appraisal Standards Board of the Appraisal Foundation. Donors should always consider choosing an appraiser who is a member of a professional organization such as the National Association of Certified Valuation Analysts.

In all cases, the donor must attach a fully completed appraisal summary to the applicable tax return.[5]

Family Limited Partnerships

The Family Limited Partnership (FLP) is a business entity that combines the advantages of a limited partnership under the Uniform Limited Partnership Act with the benefits of a family partnership under IRC § 704(e).

Partnership tax treatment means that for tax purposes, the family enterprise will be treated as a flow-through entity. Income, deductions and credits pass through to each individual partner pro rata with the tax character unaltered, and the partners report these items on their personal tax returns. Partnership distributions are generally tax free, with some exceptions. For example, distributions of cash or marketable securities in excess of a partner's basis may trigger income tax liability.

For many individuals, the tax advantage is rooted in the favorable valuation of FLP shares. The landmark case for discounted valuation, *Mandelbaum v. Commissioner*, established certain evaluating factors relevant to discounted valuation.[6] Among those noted were:

- The value of the subject corporation's privately traded securities vis-a-vis its publicly traded securities
- An analysis of the subject corporation's financial statements
- The corporation's dividend-paying capacity, its history of paying dividends, and the amount of its prior dividends
- The nature of the corporation, its history, its position in the industry, and its economic outlook.

The partnership itself is not allowed a deduction for charitable contributions of an FLP asset—the deduction flows through to the partners, who each report their pro rata share of the gift on their individual income tax returns. Such deductions are not normally limited by the partner's basis in the partnership.

Valuation is always a paramount concern in considering a gift of an FLP interest. In *Smith v. Comm'r*, the Tax Court denied an income tax deduction for charitable contributions of a minority interest in an FLP because the taxpayer had not obtained a formal appraisal of the partnership interest at the time of the gift and had not furnished an appraisal summary with the income tax returns.[7]

CAUTIONARY NOTE - Individuals and their advisors should take great care to establish and document the legitimate business purposes that lie behind the formation of the FLP (or, indeed, of any entity formed in similar circumstances). Individuals can reap real and substantial business benefits from an FLP, such as reducing management and other expenses. Advisors should carefully observe and document the appropriate organizational and operational formalities in order to protect both business owner donors and their charitable recipients.

Limited Liability Companies

A limited liability company (LLC) is a statutory form of business entity authorized in all states that offers many of the advantages available to partnerships and corporations. The LLC usually offers the tax pass-through attributes of a partnership while providing the limited liability that ordinarily exists only with a corporation. Unlike a basic FLP, no one need be in the position of a general partner, exposed to unlimited liability. The LLC extends limited liability to all owners. In many states, the LLC offers the most flexibility of any business entity.

Charitable gifts of interests in LLCs are typically taxed (as are those of a partnership interest), but the donor must take care to verify the tax filing status of the LLC. The "check-the-box regulations" expanded access to other tax classifications (including the single-member disregarded entity).[8]

S Corporations

Corporations that have elected to be taxed as pass-through entities under subchapter S of the IRC

are commonly referred to as S corporations.[9] The character of items of income, deductions, losses, and credits passes through to the shareholders.[10] Although an S corporation does not usually pay a tax, it must file an annual return on Form 1120S.

When a donor contributes S corporation stock held more than one year to a public charity, the donor generally receives a deduction for the fair market value of the stock and does not pay tax on any appreciation in the stock's value. However, the deduction must be reduced by the amount of gain that would have been ordinary income had the donor sold the stock.[11] An S corporation shareholder cannot deduct more than the shareholder's tax basis in the stock. Furthermore, a charity that accepts a gift of S corporation stock will have its income or loss from the interest treated as unrelated business income that can be taxed—even if the S corporation business activity is passive and not active. And, when the charity sells the S corporation stock, the gain or loss may be treated as unrelated business taxable income (UBTI).[12]

Funding a CRT with S Corporation Stock

Generally, a Charitable Remainder Trust (CRT) cannot be an S corporation shareholder because a CRT is not a qualified exempt organization under IRC § 501(c)(3); instead, a CRT obtains its tax-exempt status under IRC § 664. However, the IRS did issue Private Letter Ruling 9340043 (not to be considered precedent, but nevertheless instructive) that allowed an S corporation to establish a Charitable Remainder Unitrust (CRUT) with its shareholder as the non-charitable beneficiary.

The S corporation funded the CRUT with a partnership interest, but only after the partnership had been stripped of any assets that created ordinary income. When the partnership was liquidated—producing only capital gain income—the CRUT trustee could invest its share of the proceeds. The sole S corporation shareholder was the non-charitable beneficiary.

The IRS determined that the contribution of the partnership interest was considered appreciated long-term capital gain and could be deductible as such—and the deduction flowed through to the sole shareholder. The transfer of the partnership interest by the S corporation to the CRUT did not trigger capital gains taxation and the full value (including the untaxed appreciation) could grow within the CRUT. Plus, there was no incidence of UBTI in the CRUT.

FAVORABLE TREATMENT FOR SHAREHOLDERS WHEN S CORPORATIONS DONATE APPRECIATED PROPERTY

The Pension Protection Act of 2006 included a temporary provision that encouraged the donation of appreciated property by S corporations to qualified charities.

Usually, when an S corporation contributes money or other property to a charity, each shareholder takes into account the shareholder's pro rata share of the contribution in determining income tax liability. A shareholder of an S corporation reduces the basis in the stock of the S corporation by the amount of the charitable contribution that flows through to the shareholder.[13]

For example, assume an S corporation with one individual shareholder makes a charitable contribution of stock with a basis of $200 and a fair market value of $500. The IRS will treat it as a $500 charitable contribution (or a lesser amount if the special rules of section 170(e) apply) and will reduce the basis of the S corporation stock by $200.

The temporary provision states that the amount of a shareholder's basis reduction in the stock of an S corporation by reason of a charitable contribution made by the corporation will be equal to the shareholder's pro rata share of the adjusted basis of the contributed property. This provision expires December 31, 2013.[14] However, Congress has extended this rule several times, most recently on January 1, 2013. Approval of the pending S Corporation Modernization Act of 2013 would establish the provision permanently.

WHEN THE CHARITABLE INSPIRATION STRIKES

If, as Edison reportedly stated, "genius is 1% inspiration and 99% perspiration,"[15] the professional advisor may have to provide the 99% perspiration to make a client's charitable donation of a business interest work. Understanding the benefits, pitfalls and requirements of such gifts is the key to success. A well prepared advisor can help inspired clients reach their philanthropic goals and, in doing so, also further the goals of the selected charities.

Endnotes

1. Information from the Thomas Edison website: www.thomasedison.com/quotes.html.
2. Treas. Reg. Sec. 20.2031-1(b); IRC Sec. 2701.
3. IRC Sec. 170(f)(8)(A).
4. IRC Sec. 170(f)(11); Treas. Reg. Sec. 1.170A-13(b)(3)(i).
5. Defined in Treas. Reg. Sec. 1.170A-13(c)(4).
6. *Mandelbaum v. Comm'r*, T.C. Memo 1995-255 (June 12, 1995).
7. *Smith v. Comm'r*, T.C. Memo 2007-368 (Dec 17, 2007).
8. Treas. Reg. Sec. 301.7701-1.
9. IRC Sec. 1361.
10. IRC Sec. 1366.
11. IRC Sec. 170(e).
12. IRC Sec. 512(e).
13. IRC Sec. 1367.
14. Id.
15. However, these may not be Edison's actual words. An interesting discus- sion on this can be found at the Quote Investigator website at: http://quoteinvestigator.com/2012/12/14/genius-ratio/#note-5018-13.

This newsletter is only for professional advisors and only for their information and discussion. It is intended only to provide general information about charitable gifts and charitable-gift planning. This newsletter is not (1) legal, tax, accounting, or financial advice, (2) any solicitation of legal, tax, accounting, or financial services, (3) any securities or investment advice, or (4) any solicitation of securities or investment advisory services. Each professional must evaluate the tax and financial consequences of each individual situation.

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Charitable Gifts of Business Interests: 1% Inspiration, 99% Planning

In This Issue:

- General Observations on Charitable Gifts of Interests in FLPs, LLCs and S Corporations
- Family Limited Partnerships
- Limited Liability Companies
- S Corporations
- Planning and Drafting Illustration

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General Observations on Charitable Gifts of Interests in FLPs, LLCs and S Corporations

Valuation and Substantiation

The donation of a gift of a business interest first requires the donor to value the interest in the business entity. In this regard, it is essential to thoroughly understand the valuation rules of the Internal Revenue Code (IRC). Generally, a business property interest owned by the donor for longer than one year is valued at its "fair market value" (FMV)—the price at which the property would change hands between a willing buyer and a willing seller, neither being under a compulsion to buy or to sell and both having reasonable knowledge of the relevant facts.[2]

In order for the donor to claim a charitable deduction for donations valued in excess of $250, the charity must acknowledge, *contemporaneous with the gift and in writing*, the following information:

- The amount of a cash donation or a description of any non-cash property donated
- A statement of any goods or services the charity provides in consideration, in whole or part, for any cash or other property donated, including a description and good faith estimate of the value of such goods or services, and
- A statement, if applicable, of whether the charity provides any intangible religious benefits.[3]

If the value of the gift is more than $500 and less than $5,000, the written acknowledgement must also contain the following items:

- The manner and approximate date of acquisition of the property or, if the property was created or produced by the donor, the approximate date the property was substantially completed, and
- The adjusted basis of the property (other than publicly traded securities) held by the donor for less than 12 months immediately preceding the date of the gift and, when the information is available, the adjusted basis of the property (other than publicly traded securities) held for 12 months or more.[4]

For non-cash donations of $5,000 or greater, the donor must obtain a "qualified appraisal" within the meaning of IRC § 170(f)(11)(E). Any qualified appraisal must be conducted by a qualified appraiser in accordance with generally accepted appraisal standards and should assess value as of the proposed date of the gift.[5] Further technical requirements of meeting this IRC section are outlined by Treas. Reg. § 1.170A-13(c). These guidelines will be considered satisfied if the appraisal is consistent with the substance and principles of the Uniform Standards of Professional Appraisal Practice, as developed by the Appraisal Standards Board of the Appraisal Foundation.

Given the potential complexity of valuing these interests, donors should consider choosing an appraiser who is a member of a professional organization such as the American Society of Appraisers, the Institute of Business Appraisers or the National Association of Certified Valuation Analysts.

The requirements for documenting a qualified appraisal are strictly construed. In *Hendrix v. U.S.*,

Plaintiffs sought to take a charitable deduction of $287,400, and submitted an appraisal with the appropriate tax return.[6] However, the IRS disallowed the deduction and instead assessed a $100,590 deficiency. Ultimately the case came before the U.S. District Court Eastern District of Ohio.

The plaintiffs were found to have committed two significant errors. First, they failed to obtain the required contemporaneous written acknowledgements from the charity (as outlined above), and second, they did not submit a "qualified appraisal." The court discussed the appraisal issue, noting that the plaintiff's appraisal did not "contain the expected date of contribution, the terms of the agreement between Plaintiffs and the city, the qualification of Plaintiffs' appraiser (including the appraiser's background, experience, education, and any membership in professional appraisal associations), and the required statement that the appraisal was prepared for income tax purposes."[7]

While the plaintiffs argued they had substantially complied, the court disagreed: "(t)he issues are what Plaintiffs were *required* to do and submit as part of the deduction process and what they *actually* did, not what they could have done or what wishfully reparative steps they have taken years after the fact."[8] Based on this, the court found in favor of the IRS.[9]

In all cases, the donor must attach a fully completed appraisal summary to the applicable tax return (e.g., the information return in the case of a donor that is a partnership or S corporation) on which the deduction for the contribution is first claimed (or reported) by the donor.[10] Finally, as illustrated by the *Hendrix* case, the donor must maintain adequate records containing the information required by the applicable regulations.[11]

Definition of a Qualified Appraiser Under IRC § 170

IRC § 170(f)(11)(E)(ii) defines a qualified appraiser as an individual who:

(1) Has earned an appraisal designation from a recognized professional organization or has otherwise met minimum education and experience requirements set forth in regulations,

(2) Regularly performs appraisals for which the individual receives compensation, and

(3) Meets such other requirements as may be prescribed by the Secretary in regulations or other guidance.[12]

Furthermore, IRC § 170(f)(11)(E)(iii) provides that an individual will not be treated as a qualified appraiser unless that individual both demonstrates verifiable education and experience in valuing the type of property subject to the appraisal, and has not been prohibited from practicing before the IRS at any time in the three years before the date of the appraisal.[13]

Definition of a Qualified Appraisal Under IRC § 170

Under Reg. § 1.170A-13(c)(3), a qualified appraisal is an appraisal document that:

(1) Relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property and not later than the due date (including extensions) of the return on which a deduction is first claimed under IRC § 170;

(2) Is prepared, signed, and dated by a qualified appraiser;

(3) Includes a description of the property appraised, the fair market value of the property on the date of contribution and the specific basis for the valuation, a statement that such appraisal was prepared for income tax purposes, plus an attribution of the qualifications of the appraiser as well as the signature and taxpayer identification number of such appraiser; and

(4) States that the appraisal did not involve an appraisal fee that violates certain prescribed rules.

Property Subject to Restrictive Arrangements and Valuation

IRC § 2703 concerns the valuation of transfers of business interests and how restrictive language in the transfer document may affect the valuation.[14]

The general rule of §2703 states:

For purposes of this subtitle, the value of any property shall be determined without regard to—

(1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right), or

(2) any restriction on the right to sell or use such property.[15]

While this seems to rule out most discounts on business entity transfers, the exceptions do provide planning opportunities. When an individual enters into an agreement to transfer a business to the "natural objects of his or her bounty" (usually family members), then estate, gift, and generation-skipping taxes are assessed without regard to this agreed value unless:

- It is a bona fide business arrangement,
- It is not a device to transfer the decedent's property to members of the decedent's family for less than full and adequate consideration in money or in money's worth, and
- It has terms comparable to those entered into by persons in an arm's length transaction.[16]

For the professional advisor, the key is to review any agreements relating to the transfer of a closely held business entity at the beginning of the charitable planning process, prior to securing a professional appraisal. The advisor should look for items that would be outside of a standard arm's length agreement. Any existing restrictions may be structured to be similar to those found in a third party agreement.

Unrelated Business Taxable Income

Gifts of an FLP, LLC or S corporation interest to a charity can cause unrelated business taxable income (UBTI) to the charitable organization under IRC § 512(c). One way that a charity or trustee of a charitable remainder trust can invest in entities that normally produce UBTI (i.e., hedge funds or active business interests) without harm is to interpose a bona fide corporation between the activity and the charitable entity. In Private Letter Ruling 200252096, (PLRs cannot be considered precedent, but are nevertheless instructive), a charitable remainder trust (CRT) formed a wholly owned for-profit corporation subject to income tax. The terms of the CRT established several business purposes for forming a wholly owned corporation to make investments, including flexibility in disposing of investments by using the corporation, which the CRT itself would not have had otherwise. The IRS ruled that if the investments held by the CRT were *directly* owned they would be UBTI. However, the income arrived indirectly through the corporation, which then paid dividends to the CRT. Dividend income is not taxable under IRC § 512(b)(1) or subject to the "controlled organization" rules of IRC § 512(b)(13). Further, since the CRT had not incurred debt in financing its interest in the corporation, the dividend income was not debt-financed income described in IRC § 514. Since the corporate stock owned by the CRT was not debt-financed property, dividends paid on the stock were exempt from UBTI under IRC § 512(b)(1).

Family Limited Partnerships

The Family Limited Partnership (FLP) is a business entity that combines the advantages of a limited partnership under the Uniform Limited Partnership Act with the benefits of a family partnership under IRC § 704(e).

Partnership tax treatment means that for tax purposes, the family enterprise will be treated as a flow-through entity. Income, deductions and credits pass through to each individual partner pro rata with the tax character unaltered, and the partners report these items on their personal tax returns.

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

Forming an FLP can help to:

- Centralize and coordinate business management
- Provide for successor ownership of the family business
- Preserve and pass family business assets to members of younger generations
- Provide management flexibility, permitting adjustments to changing circumstances or relationships with younger family members
- Reduce income taxes by shifting some business income to family members in lower tax brackets
- Provide for successor ownership of the family business
- Save gift and estate taxes as wealth is transferred between generations

For many individuals, the tax advantage is rooted in the favorable valuation of FLP shares. The landmark case for discounted valuation, *Mandelbaum v. Commissioner*, established certain evaluating factors relevant to discounted valuation.[17] Among those noted were:

- The value of the subject corporation's privately traded securities vis-a-vis its publicly traded securities

- An analysis of the subject corporation's financial statements
- The corporation's dividend-paying capacity, its history of paying dividends, and the amount of its prior dividends
- The nature of the corporation, its history, its position in the industry, and its economic outlook.

The partnership itself is not allowed a deduction for charitable contributions of an FLP asset—the deduction flows through to the partners, who each report their pro rata share of the gift on their individual income tax returns. Such deductions are not normally limited by the partner's basis in the partnership.

An interesting application of this concept was covered in Revenue Ruling 2004-5 (2004-3 IRB 295). The issue concerned whether a trust comprised of only a partnership interest was prohibited from taking a charitable deduction when the partnership itself made a charitable contribution. The trust's governing instrument did not authorize the trustee to make charitable contributions. The IRS noted that the governing instrument must give the trustee the authority to make charitable contributions in order for a trust to claim a charitable deduction under IRC § 642(c). Nevertheless, if the partnership makes a charitable contribution, any future income from the donated interest is never available to the trust. And, for federal tax purposes, the trust must take into account its distributive share of the partnership's income, gain, loss, deductions (including charitable contributions) and credits. Given these circumstances, the trust's distributive share of a charitable contribution by a partnership would be allowed under IRC § 642(c), despite the fact that the trust's governing instrument does not authorize the trustee to make charitable contributions.[18]

Valuation is always a paramount concern in considering a gift of an FLP interest. In *Smith v. Comm'r*, the Tax Court denied an income tax deduction for charitable contributions of a minority interest in an FLP because the taxpayer had not obtained a formal appraisal of the partnership interest at the time of the gift and had not furnished an appraisal summary with the income tax returns.[19] The court examined and rejected a submitted appraisal prepared by the taxpayer's CPA, who had no qualifications as an appraiser and did not prepare a full explanation of the analysis.

A second submitted appraisal was done by a qualified appraiser, but it valued only the underlying closely held corporation and not the limited partnership interest (nor did the short letters from the appraiser attached to some of the returns qualify as an appraisal summary). To avoid the problems evidenced in *Smith*, FLP shares should be valued by a qualified appraiser that agrees to take a central role in planning a charitable gift.

A partner who takes distributed property from the FLP and, in turn, donates such property to a charity will usually have the same basis and holding period as did the partnership.[20] Any money received in the same transaction will reduce the partner's adjusted basis.[21]

Debt undertaken by the partner to acquire the partnership interest, or by the partnership itself to support partnership investments, may bring the bargain-sale rules into play.[22]

The donor must be careful in the contribution of a limited partner's interest in a limited partnership subject to non-recourse liabilities. In *Goodman, et al v. U.S.*, the court noted that the amount of the donor taxpayer's share of partnership liabilities at the time of the transfer constituted an amount realized by the taxpayer.[23] Thus, it was a bargain sale within the meaning of IRC § 170 and 1011(b). Accordingly, the unfortunate taxpayer recognized a gain on the transfer equal to the excess of the amount realized by the taxpayer over that portion of the adjusted basis of the taxpayer's partnership interest, allocable to the sale under IRC § 1011(b).

Using Family Limited Partnership Interests to Fund Family Lead Trusts

Under the right circumstances, individuals can use family lead trusts to transfer property to family members with low gift tax costs. Trust income goes to charity for a specified number of years, and then the trust terminates and assets are distributed estate-tax free to family members.

Paying modest gift tax currently on property transferred to a family lead trust is often preferable to paying estate tax later on the appreciated values—even when the time value of money is taken into account. Further, the gift tax calculation is more advantageous because it is "tax exclusive." On the other hand, the estate tax calculation is "tax inclusive," using a base that includes all assets in the

gross estate, including those that will be used to pay the tax itself.

The grantor receives a gift tax charitable deduction for the present value of the family lead trust income expected to pass to charity. Paying some gift tax now on the non-charitable portion, and possibly settling difficult valuation problems during life, may be preferable to the personal representative negotiating (or perhaps litigating) valuation issues with the IRS later after values have increased and tax rules may have changed for the worse.

The value of the assets subject to the gift tax can be reduced further by using family limited partnership interests or closely held stock entitled to discounts. If minority-discount assets are used to fund a family lead trust, the nominal value of the trust for purposes of the federal gift tax liability is reduced even though the assets are still generating the same total return on the underlying property.

For example, if a 30% discount is applied to assets worth $20 million and generating an 8% return on investment (ROI), the nominal trust value is reduced to $14 million and the effective ROI is now 11.43%. With a lower nominal value, the trust assets can now support a 7.15% annuity payment to charity, thus generating a far lower gift tax liability than if the trust were valued at $20 million and paid a 5% annuity payment of $1 million per year to charity.

Excess earnings inside a family lead trust may be used to significantly leverage or increase the ultimate distribution to family members by including a sizable life insurance policy on the life of the grantor inside the trust. The generally tax-free insurance proceeds may also provide the liquidity needed to pay the estate tax on assets passing outside the trust.

Cautionary Note

Individuals and their advisors should take great care to establish and document the legitimate non-tax business purposes that lie behind the formation of the FLP (or, indeed, of any entity formed in similar circumstances). Individuals can reap real and substantial business benefits from an FLP such as streamlining, reducing management and other expenses, centralizing the flow of information and decision-making, and better monitoring the performance of various lines of business or investments.

The IRS is especially diligent in examining FLPs. A long series of FLP rulings and cases over the past two decades has outlined what is acceptable in the planning and execution of the FLP model [e.g., *Estate of Bongard*, 124 T.C. 95 (2005)].[24] Advisors should carefully observe and document the appropriate organizational and operational formalities in order to protect both business owner donors and their charitable recipients.

Limited Liability Companies

A limited liability company (LLC) is a statutory form of business entity authorized in all states that offers many of the advantages available to partnerships and corporations. The LLC usually offers the tax pass-through attributes of a partnership while providing the limited liability that ordinarily exists only with a corporation. Unlike a basic FLP, no one need be in the position of a general partner, exposed to unlimited liability. The LLC extends limited liability to all owners. In many states, the LLC offers the most flexibility of any business entity.

LLC interest holders are typically referred to as "members," their enterprise is governed by "Articles of Organization," and overall guidance is provided by a "manager" or "managers." It is possible that an LLC may even be a converted partnership that changed its form of organization to seek greater protection from liability. Such conversions may be made tax free.[25]

Unlike limited partners, LLC members may materially participate in management while continuing to enjoy limited liability. LLCs generally offer more flexibility and more favorable tax treatment than S corporations. In addition, the restrictions as to who can be permitted as an S shareholder do not apply to membership in an LLC.[26]

Charitable gifts of interests in LLCs are typically taxed (as are those of a partnership interest), but the donor must take care to verify the tax filing status of the LLC. The "check-the-box regulations" expanded access to other tax classifications (including the single-member disregarded entity).[27]

S Corporations

Corporations that have elected to be taxed as pass-through entities under subchapter S of the IRC are commonly referred to as S corporations.[28] The character of items of income, deductions, losses, and credits passes through to the shareholders.[29]

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, or charitable organizations exempt from income tax under IRC § 501(a)
- There must be only one class of stock issued and outstanding (for example, a corporation with both common and preferred stock would not be eligible).[30]

When a donor contributes S corporation stock held more than one year to a public charity, the donor generally receives a deduction for the fair market value of the stock and does not pay tax on any appreciation in the stock's value. However, the deduction must be reduced by the amount of gain that would have been ordinary income had the donor sold the stock.[31] An S corporation shareholder cannot deduct more than the shareholder's tax basis in the stock.

Furthermore, a charity that accepts a gift of S corporation stock will have its income or loss from the interest treated as unrelated business income that can be taxed—even if the S corporation business activity is passive and not active. And, when the charity sells the S corporation stock, the gain or loss may be treated as unrelated business taxable income.[32]

Funding a CLT with S Corporation Stock

Funding a Charitable Lead Trust (CLT) with S corporation stock can be difficult because a taxable trust cannot own S corporation stock.[33] However, careful planning can open possibilities for an S corporation shareholder interested in creating a CLT.

Grantor CLT: A private letter ruling stated that a grantor CLT can hold S corporation shares because the grantor constructively holds the shares.[34] The grantor will receive an income tax deduction for the fair market value of the stock, subject to valuation discounts. During the CLT term, the trust income is taxable to the grantor (even though the grantor doesn't actually receive the income). Finally, when the CLT terminates, the S corporation stock will be returned to the grantor.

One necessary precaution is to include a provision in the CLT agreement to convert the trust to a permitted S corporation shareholder in the event the grantor dies before the CLT is scheduled to terminate. Without such language, the S corporation may be disqualified when the CLT ceases to be a grantor trust.

Non-Grantor CLT: A non-grantor CLT is generally not permitted as an S corporation shareholder.[35] However, the CLT could qualify as an electing small business trust (ESBT) and hold such stock. To qualify, a CLT must meet the following strict requirements:

- All beneficiaries of the CLT must be living people, estates or charities.
- The S corporation stock must be gifted to the CLT (not bought).
- The CLT cannot be a qualified Subchapter S trust.
- The beneficiaries must all be considered shareholders of the S corporation.[36]

Funding a CRT with S Corporation Stock

Generally, a Charitable Remainder Trust (CRT) cannot be an S corporation shareholder because a CRT is not a qualified exempt organization under IRC § 501(c)(3); instead, a CRT obtains its tax-exempt status under IRC § 664. However, the IRS did issue Private Letter Ruling 9340043 that allowed an S corporation to establish a Charitable Remainder Unitrust (CRUT) with its shareholder as the non-charitable beneficiary.

The S corporation funded the CRUT with a partnership interest, but only after the partnership had been stripped of any assets that created ordinary income. When the partnership was liquidated—producing only capital gain income—the CRUT trustee could invest its share of the proceeds. The sole S corporation shareholder was the non-charitable beneficiary.

The IRS determined that the contribution of the partnership interest was considered appreciated long-term capital gain and could be deductible as such—and the deduction flowed through to the sole shareholder. The transfer of the partnership interest by the S corporation to the CRUT did not trigger capital gains taxation and the full value (including the untaxed appreciation) could grow within the CRUT. Plus, there was no incidence of UBTI in the CRUT.

Illustration

Planning and Drafting Considerations

Clearly, FLPs and LLCs offer advantages to holders of their shares which are not available to S corporation shareholders. Nonetheless, a gift of any type of appreciated business interest to a charitable recipient is likely to remain more advantageous than a gift of cash.

S Corporation*

1.	FMV	$100,000
2.	Basis	$20,000
3.	Capital Gains tax not paid	$12,000
4.	Tax value of deduction	$35,000
5.	Total savings (3 & 4)	$47,000
6.	Cost of gift	$53,000
	UBTI tax owed by charity	$27,650
	Total to charity	$72,350

Partnership*

1.	FMV	$100,000
2.	Basis	$20,000
3.	Capital Gains tax not paid	$12,000
4.	Tax value of deduction	$35,000
5.	Total savings (3 & 4)	$47,000
6.	Cost of gift	$53,000
	UBTI tax owed by charity	$-0-
	Total to charity	$100,000

LLC*

1.	FMV	$100,000
2.	Basis	$20,000
3.	Capital Gains tax not paid	$12,000
4.	Tax value of deduction	$35,000
5.	Total savings (3 & 4)	$47,000
6.	Cost of gift	$53,000
	UBTI tax owed by charity	$-0-
	Total to charity	$100,000

Gift of Cash*

1.	FMV	$100,000
2.	Basis	$20,000
3.	Capital Gain tax paid	$12,000
4.	Tax value of deduction**	$30,800
5.	Total savings	$30,800
6.	Cost of gift	$69,200
	UBTI tax owed by charity	$-0-
	Total to charity	$88,000

* A 35% income tax bracket has been used in making this comparison.

** 35% of $88,000

When the Charitable Inspiration Strikes

If, as Edison reportedly stated, "genius is 1% inspiration and 99% perspiration,"[37] the professional advisor may have to provide the 99% perspiration to make a client's charitable donation of a business interest work. Understanding the benefits, pitfalls and requirements of such gifts is the key to success. A well prepared advisor can help inspired clients reach their philanthropic goals and, in doing so, also further the goals of the selected charities.

Endnotes

1 Information from the Thomas Edison website: "http://www.thomasedison.com/quotes.html" www.thomasedison.com/quotes.html.
2 Treas. Reg. § 20.2031-1(b)]; IRC § 2701.
3 IRC § 170(f)(8)(A).
4 IRC §170(f)(11); Treas. Reg. §1.170A-13(b)(3)(i).
5 Treas. Reg. § 25.2512-3.
6 *Hendrix v. United States*, 2010 U.S. Dist. LEXIS 73999 (S.D. Ohio 2010).
7 Id at 10.
8 Id at 15.
9 Id at 22.
10 Defined in Treas. Reg. § 1.170A-13(c)(4).
11 IRC §170(f)(11); Treas. Reg. §1.170A-13(c)(1)(i); Treas. Reg. § 1.170A-13 (b)(2)(ii).
12 IRC § 170(f)(11)(E)(ii).
13 IRC §170(f)(11)(E)(iii).
14 IRC § 2703.
15 IRC § 2703(a).
16 IRC § 2703(b); Treas. Reg. § 25.2703(b).
17 *Mandelbaum v. Comm'r*, T.C. Memo 1995-255 (June 12, 1995).
18 Revenue Ruling 2004-5 (2004-3 IRB 295).
19 *Smith v. Comm'r*, TC Memo 2007-368 (Dec 17, 2007).
20 IRC § 732(a); Treas. Reg. § 1.732-1(a).
21 IRC § 132(b); Treas. Reg. §1.732-1(b).
22 IRC § 170(b) and (c), 1001 and 1011(b); Treas. Reg. §1.170A-4(c)(2).
23 *Goodman, et al v. U.S.*, 85 AFTR 2d 2000-438 (S.D. FL, 1999).
24 *Estate of Bongard v. Comm'r*, 124 T.C. No. 8, March 15, 2005.
25 Rev. Rul. 95-37, 1995-1 CB 130.
26 The S-corp restrictions are found in IRC §1361.
27 Treas. Reg. § 301.7701-1.
28 IRC § 1361.
29 IRC § 1366.
30 IRC § 1361(b).
31 IRC § 170(e).
32 IRC § 512(e).
33 IRC § 1361(b)(1)(B).
34 See PLR 199936031, PLR 199908002.
35 IRC § 1361(b)(1)(B).
36 IRC § 1361(e).
37 However, these may not be Edison's actual words. An interesting discussion on this can be found at the Quote Investigator website at: http://quoteinvestigator.com/2012/12/14/genius-ratio

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This booklet is only for professional advisors and only for their information and discussion. It is intended only to provide general information about charitable gifts and charitable-gift planning. This booklet is not (1) legal, tax, accounting, or financial advice, (2) any solicitation of legal, tax, accounting, or financial services, (3) any securities or investment advice, or (4) any solicitation of securities or investment advisory services. Each professional must evaluate the tax and financial consequences of each individual situation.

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For non-cash donations of $5,000 or greater, the donor must obtain a "qualified appraisal" by a "qualified appraiser" as described under IRC § 170(f)(11)(E). These guidelines will be considered satisfied if the appraisal is consistent with the substance and principles of the Uniform Standards of Professional Appraisal Practice as developed by the Appraisal Standards Board of the Appraisal Foundation. Donors should always consider choosing an appraiser who is a member of a professional organization such as the National Association of Certified Valuation Analysts.

In all cases, the donor must attach a fully completed appraisal summary to the applicable tax return.[5]

Family Limited Partnerships

The Family Limited Partnership (FLP) is a business entity that combines the advantages of a limited partnership under the Uniform Limited Partnership Act with the benefits of a family partnership under IRC § 704(e).

Partnership tax treatment means that for tax purposes, the family enterprise will be treated as a flow-through entity. Income, deductions and credits pass through to each individual partner pro rata with the tax character unaltered, and the partners report these items on their personal tax returns. Partnership distributions are generally tax free, with some exceptions. For example, distributions of cash or marketable securities in excess of a partner's basis may trigger income tax liability.

For many individuals, the tax advantage is rooted in the favorable valuation of FLP shares. The landmark case for discounted valuation, *Mandelbaum v. Commissioner*, established certain evaluating factors relevant to discounted valuation.[6] Among those noted were:

- The value of the subject corporation's privately traded securities vis-a-vis its publicly traded securities
- An analysis of the subject corporation's financial statements
- The corporation's dividend-paying capacity, its history of paying dividends, and the amount of its prior dividends
- The nature of the corporation, its history, its position in the industry, and its economic outlook.

The partnership itself is not allowed a deduction for charitable contributions of an FLP asset—the deduction flows through to the partners, who each report their pro rata share of the gift on their individual income tax returns. Such deductions are not normally limited by the partner's basis in the partnership.

Valuation is always a paramount concern in considering a gift of an FLP interest. In *Smith v. Comm'r*, the Tax Court denied an income tax deduction for charitable contributions of a minority interest in an FLP because the taxpayer had not obtained a formal appraisal of the partnership interest at the time of the gift and had not furnished an appraisal summary with the income tax returns.[7]

CAUTIONARY NOTE - Individuals and their advisors should take great care to establish and document the legitimate business purposes that lie behind the formation of the FLP (or, indeed, of any entity formed in similar circumstances). Individuals can reap real and substantial business benefits from an FLP, such as reducing management and other expenses. Advisors should carefully observe and document the appropriate organizational and operational formalities in order to protect both business owner donors and their charitable recipients.

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S Corporations

Corporations that have elected to be taxed as pass-through entities under subchapter S of the IRC

are commonly referred to as S corporations.[9] The character of items of income, deductions, losses, and credits passes through to the shareholders.[10] Although an S corporation does not usually pay a tax, it must file an annual return on Form 1120S.

When a donor contributes S corporation stock held more than one year to a public charity, the donor generally receives a deduction for the fair market value of the stock and does not pay tax on any appreciation in the stock's value. However, the deduction must be reduced by the amount of gain that would have been ordinary income had the donor sold the stock.[11] An S corporation shareholder cannot deduct more than the shareholder's tax basis in the stock. Furthermore, a charity that accepts a gift of S corporation stock will have its income or loss from the interest treated as unrelated business income that can be taxed—even if the S corporation business activity is passive and not active. And, when the charity sells the S corporation stock, the gain or loss may be treated as unrelated business taxable income (UBTI).[12]

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The IRS determined that the contribution of the partnership interest was considered appreciated long-term capital gain and could be deductible as such—and the deduction flowed through to the sole shareholder. The transfer of the partnership interest by the S corporation to the CRUT did not trigger capital gains taxation and the full value (including the untaxed appreciation) could grow within the CRUT. Plus, there was no incidence of UBTI in the CRUT.

FAVORABLE TREATMENT FOR SHAREHOLDERS WHEN S CORPORATIONS DONATE APPRECIATED PROPERTY

The Pension Protection Act of 2006 included a **temporary** provision that encouraged the donation of appreciated property by S corporations to qualified charities.

Usually, when an S corporation contributes money or other property to a charity, each shareholder takes into account the shareholder's pro rata share of the contribution in determining income tax liability. A shareholder of an S corporation reduces the basis in the stock of the S corporation by the amount of the charitable contribution that flows through to the shareholder.[13]

For example, assume an S corporation with one individual shareholder makes a charitable contribution of stock with a basis of $200 and a fair market value of $500. The IRS will treat it as a $500 charitable contribution (or a lesser amount if the special rules of section 170(e) apply) and will reduce the basis of the S corporation stock by $200.

The temporary provision states that the amount of a shareholder's basis reduction in the stock of an S corporation by reason of a charitable contribution made by the corporation will be equal to the shareholder's pro rata share of the adjusted basis of the contributed property. This provision expires December 31, 2013.[14] However, Congress has extended this rule several times, most recently on January 1, 2013. Approval of the pending S Corporation Modernization Act of 2013 would establish the provision permanently.

WHEN THE CHARITABLE INSPIRATION STRIKES

If, as Edison reportedly stated, "genius is 1% inspiration and 99% perspiration,"[15] the professional advisor may have to provide the 99% perspiration to make a client's charitable donation of a business interest work. Understanding the benefits, pitfalls and requirements of such gifts is the key to success. A well prepared advisor can help inspired clients reach their philanthropic goals and, in doing so, also further the goals of the selected charities.

Endnotes

1 Information from the Thomas Edison website: www.thomasedison.com/quotes.html.

2 Treas. Reg. Sec. 20.2031-1(b); IRC Sec. 2701.

3 IRC Sec. 170(f)(8)(A).

4 IRC Sec. 170(f)(11); Treas. Reg. Sec. 1.170A-13(b)(3)(i).

5 Defined in Treas. Reg. Sec. 1.170A-13(c)(4).

6 *Mandelbaum v. Comm'r*, T.C. Memo 1995-255 (June 12, 1995).

7 *Smith v. Comm'r*, T.C. Memo 2007-368 (Dec 17, 2007).

8 Treas. Reg. Sec. 301.7701-1.

9 IRC Sec. 1361.

10 IRC Sec. 1366.

11 IRC Sec. 170(e).

12 IRC Sec. 512(e).

13 IRC Sec. 1367.

14 Id.

15 However, these may not be Edison's actual words. An interesting discus- sion on this can be found at the Quote Investigator website at: http://quoteinvestigator.com/2012/12/14/genius-ratio/#note-5018-13.

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Charitable Gifts of Business Interests: 1% Inspiration, 99% Planning

In This Issue:

- General Observations on Charitable Gifts of Interests in FLPs, LLCs and S Corporations
- Family Limited Partnerships
- Limited Liability Companies
- S Corporations
- Planning and Drafting Illustration

Thomas Edison received 1,093 patents for his life's work and is renowned as one of history's greatest inventors. His creations were not happenstance; rather, they resulted from hard work and planning. Edison noted: "I never did anything worth doing entirely by accident.... Almost none of my inventions were derived in that manner. They were achieved by having trained myself to be analytical and to endure and tolerate hard work."

"Genius," he said, "is 1% inspiration and 99% perspiration."[1]

A donor planning a charitable gift of an interest in a business entity might say something similar. The idea only makes up about one percent of the gift's success. To make it truly serve the needs of both donor and charity requires employing Edison's work ethic and suffering the perspiration of proper planning. A charitable gift of an interest in a business entity can offer many advantages over a cash gift, but only if properly planned and executed. A poorly planned or incorrectly executed gift can result in a lost charitable tax deduction for the donor and/or taxation to the charity.

This issue of ***The Good Advisor*** provides an overview of this rewarding but complex and tax-sensitive area of practice, including the basics of charitable gifts of interests in family limited partnerships (FLPs), limited liability companies (LLCs) and S corporations, and an examination of some of the potential benefits and problems for both donors and charities.

General Observations on Charitable Gifts of Interests in FLPs, LLCs and S Corporations

Valuation and Substantiation

The donation of a gift of a business interest first requires the donor to value the interest in the business entity. In this regard, it is essential to thoroughly understand the valuation rules of the Internal Revenue Code (IRC). Generally, a business property interest owned by the donor for longer than one year is valued at its "fair market value" (FMV)—the price at which the property would change hands between a willing buyer and a willing seller, neither being under a compulsion to buy or to sell and both having reasonable knowledge of the relevant facts.[2]

In order for the donor to claim a charitable deduction for donations valued in excess of $250, the charity must acknowledge, *contemporaneous with the gift and in writing*, the following information:

- The amount of a cash donation or a description of any non-cash property donated
- A statement of any goods or services the charity provides in consideration, in whole or part, for any cash or other property donated, including a description and good faith estimate of the value of such goods or services, and
- A statement, if applicable, of whether the charity provides any intangible religious benefits.[3]

If the value of the gift is more than $500 and less than $5,000, the written acknowledgement must also contain the following items:

- The manner and approximate date of acquisition of the property or, if the property was created or produced by the donor, the approximate date the property was substantially completed, and
- The adjusted basis of the property (other than publicly traded securities) held by the donor for less than 12 months immediately preceding the date of the gift and, when the information is available, the adjusted basis of the property (other than publicly traded securities) held for 12 months or more.[4]

For non-cash donations of $5,000 or greater, the donor must obtain a "qualified appraisal" within the meaning of IRC § 170(f)(11)(E). Any qualified appraisal must be conducted by a qualified appraiser in accordance with generally accepted appraisal standards and should assess value as of the proposed date of the gift.[5] Further technical requirements of meeting this IRC section are outlined by Treas. Reg. § 1.170A-13(c). These guidelines will be considered satisfied if the appraisal is consistent with the substance and principles of the Uniform Standards of Professional Appraisal Practice, as developed by the Appraisal Standards Board of the Appraisal Foundation.

Given the potential complexity of valuing these interests, donors should consider choosing an appraiser who is a member of a professional organization such as the American Society of Appraisers, the Institute of Business Appraisers or the National Association of Certified Valuation Analysts.

The requirements for documenting a qualified appraisal are strictly construed. In *Hendrix v. U.S.*,

Plaintiffs sought to take a charitable deduction of $287,400, and submitted an appraisal with the appropriate tax return.[6] However, the IRS disallowed the deduction and instead assessed a $100,590 deficiency. Ultimately the case came before the U.S. District Court Eastern District of Ohio.

The plaintiffs were found to have committed two significant errors. First, they failed to obtain the required contemporaneous written acknowledgements from the charity (as outlined above), and second, they did not submit a "qualified appraisal." The court discussed the appraisal issue, noting that the plaintiff's appraisal did not "contain the expected date of contribution, the terms of the agreement between Plaintiffs and the city, the qualification of Plaintiffs' appraiser (including the appraiser's background, experience, education, and any membership in professional appraisal associations), and the required statement that the appraisal was prepared for income tax purposes."[7]

While the plaintiffs argued they had substantially complied, the court disagreed: "(t)he issues are what Plaintiffs were *required* to do and submit as part of the deduction process and what they *actually* did, not what they could have done or what wishfully reparative steps they have taken years after the fact."[8] Based on this, the court found in favor of the IRS.[9]

In all cases, the donor must attach a fully completed appraisal summary to the applicable tax return (e.g., the information return in the case of a donor that is a partnership or S corporation) on which the deduction for the contribution is first claimed (or reported) by the donor.[10] Finally, as illustrated by the *Hendrix* case, the donor must maintain adequate records containing the information required by the applicable regulations.[11]

Definition of a Qualified Appraiser Under IRC § 170

IRC § 170(f)(11)(E)(ii) defines a qualified appraiser as an individual who:

(1) Has earned an appraisal designation from a recognized professional organization or has otherwise met minimum education and experience requirements set forth in regulations,

(2) Regularly performs appraisals for which the individual receives compensation, and

(3) Meets such other requirements as may be prescribed by the Secretary in regulations or other guidance.[12]

Furthermore, IRC § 170(f)(11)(E)(iii) provides that an individual will not be treated as a qualified appraiser unless that individual both demonstrates verifiable education and experience in valuing the type of property subject to the appraisal, and has not been prohibited from practicing before the IRS at any time in the three years before the date of the appraisal.[13]

Definition of a Qualified Appraisal Under IRC § 170

Under Reg. § 1.170A-13(c)(3), a qualified appraisal is an appraisal document that:

(1) Relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property and not later than the due date (including extensions) of the return on which a deduction is first claimed under IRC § 170;

(2) Is prepared, signed, and dated by a qualified appraiser;

(3) Includes a description of the property appraised, the fair market value of the property on the date of contribution and the specific basis for the valuation, a statement that such appraisal was prepared for income tax purposes, plus an attribution of the qualifications of the appraiser as well as the signature and taxpayer identification number of such appraiser; and

(4) States that the appraisal did not involve an appraisal fee that violates certain prescribed rules.

Property Subject to Restrictive Arrangements and Valuation

IRC § 2703 concerns the valuation of transfers of business interests and how restrictive language in the transfer document may affect the valuation.[14]

The general rule of §2703 states:

For purposes of this subtitle, the value of any property shall be determined without regard to—

(1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right), or

(2) any restriction on the right to sell or use such property.[15]

While this seems to rule out most discounts on business entity transfers, the exceptions do provide planning opportunities. When an individual enters into an agreement to transfer a business to the "natural objects of his or her bounty" (usually family members), then estate, gift, and generation-skipping taxes are assessed without regard to this agreed value unless:

- It is a bona fide business arrangement,
- It is not a device to transfer the decedent's property to members of the decedent's family for less than full and adequate consideration in money or in money's worth, and
- It has terms comparable to those entered into by persons in an arm's length transaction.[16]

For the professional advisor, the key is to review any agreements relating to the transfer of a closely held business entity at the beginning of the charitable planning process, prior to securing a professional appraisal. The advisor should look for items that would be outside of a standard arm's length agreement. Any existing restrictions may be structured to be similar to those found in a third party agreement.

Unrelated Business Taxable Income

Gifts of an FLP, LLC or S corporation interest to a charity can cause unrelated business taxable income (UBTI) to the charitable organization under IRC § 512(c). One way that a charity or trustee of a charitable remainder trust can invest in entities that normally produce UBTI (i.e., hedge funds or active business interests) without harm is to interpose a bona fide corporation between the activity and the charitable entity. In Private Letter Ruling 200252096, (PLRs cannot be considered precedent, but are nevertheless instructive), a charitable remainder trust (CRT) formed a wholly owned for-profit corporation subject to income tax. The terms of the CRT established several business purposes for forming a wholly owned corporation to make investments, including flexibility in disposing of investments by using the corporation, which the CRT itself would not have had otherwise. The IRS ruled that if the investments held by the CRT were *directly* owned they would be UBTI. However, the income arrived indirectly through the corporation, which then paid dividends to the CRT. Dividend income is not taxable under IRC § 512(b)(1) or subject to the "controlled organization" rules of IRC § 512(b)(13). Further, since the CRT had not incurred debt in financing its interest in the corporation, the dividend income was not debt-financed income described in IRC § 514. Since the corporate stock owned by the CRT was not debt-financed property, dividends paid on the stock were exempt from UBTI under IRC § 512(b)(1).

Family Limited Partnerships

The Family Limited Partnership (FLP) is a business entity that combines the advantages of a limited partnership under the Uniform Limited Partnership Act with the benefits of a family partnership under IRC § 704(e).

Partnership tax treatment means that for tax purposes, the family enterprise will be treated as a flow-through entity. Income, deductions and credits pass through to each individual partner pro rata with the tax character unaltered, and the partners report these items on their personal tax returns.

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

Forming an FLP can help to:

- Centralize and coordinate business management
- Provide for successor ownership of the family business
- Preserve and pass family business assets to members of younger generations
- Provide management flexibility, permitting adjustments to changing circumstances or relationships with younger family members
- Reduce income taxes by shifting some business income to family members in lower tax brackets
- Provide for successor ownership of the family business
- Save gift and estate taxes as wealth is transferred between generations

For many individuals, the tax advantage is rooted in the favorable valuation of FLP shares. The landmark case for discounted valuation, *Mandelbaum v. Commissioner*, established certain evaluating factors relevant to discounted valuation.[17] Among those noted were:

- The value of the subject corporation's privately traded securities vis-a-vis its publicly traded securities

- An analysis of the subject corporation's financial statements
- The corporation's dividend-paying capacity, its history of paying dividends, and the amount of its prior dividends
- The nature of the corporation, its history, its position in the industry, and its economic outlook.

The partnership itself is not allowed a deduction for charitable contributions of an FLP asset—the deduction flows through to the partners, who each report their pro rata share of the gift on their individual income tax returns. Such deductions are not normally limited by the partner's basis in the partnership.

An interesting application of this concept was covered in Revenue Ruling 2004-5 (2004-3 IRB 295). The issue concerned whether a trust comprised of only a partnership interest was prohibited from taking a charitable deduction when the partnership itself made a charitable contribution. The trust's governing instrument did not authorize the trustee to make charitable contributions. The IRS noted that the governing instrument must give the trustee the authority to make charitable contributions in order for a trust to claim a charitable deduction under IRC § 642(c). Nevertheless, if the partnership makes a charitable contribution, any future income from the donated interest is never available to the trust. And, for federal tax purposes, the trust must take into account its distributive share of the partnership's income, gain, loss, deductions (including charitable contributions) and credits. Given these circumstances, the trust's distributive share of a charitable contribution by a partnership would be allowed under IRC § 642(c), despite the fact that the trust's governing instrument does not authorize the trustee to make charitable contributions.[18]

Valuation is always a paramount concern in considering a gift of an FLP interest. In *Smith v. Comm'r*, the Tax Court denied an income tax deduction for charitable contributions of a minority interest in an FLP because the taxpayer had not obtained a formal appraisal of the partnership interest at the time of the gift and had not furnished an appraisal summary with the income tax returns.[19] The court examined and rejected a submitted appraisal prepared by the taxpayer's CPA, who had no qualifications as an appraiser and did not prepare a full explanation of the analysis.

A second submitted appraisal was done by a qualified appraiser, but it valued only the underlying closely held corporation and not the limited partnership interest (nor did the short letters from the appraiser attached to some of the returns qualify as an appraisal summary). To avoid the problems evidenced in *Smith*, FLP shares should be valued by a qualified appraiser that agrees to take a central role in planning a charitable gift.

A partner who takes distributed property from the FLP and, in turn, donates such property to a charity will usually have the same basis and holding period as did the partnership.[20] Any money received in the same transaction will reduce the partner's adjusted basis.[21]

Debt undertaken by the partner to acquire the partnership interest, or by the partnership itself to support partnership investments, may bring the bargain-sale rules into play.[22]

The donor must be careful in the contribution of a limited partner's interest in a limited partnership subject to non-recourse liabilities. In *Goodman, et al v. U.S.*, the court noted that the amount of the donor taxpayer's share of partnership liabilities at the time of the transfer constituted an amount realized by the taxpayer.[23] Thus, it was a bargain sale within the meaning of IRC § 170 and 1011(b). Accordingly, the unfortunate taxpayer recognized a gain on the transfer equal to the excess of the amount realized by the taxpayer over that portion of the adjusted basis of the taxpayer's partnership interest, allocable to the sale under IRC § 1011(b).

Using Family Limited Partnership Interests to Fund Family Lead Trusts

Under the right circumstances, individuals can use family lead trusts to transfer property to family members with low gift tax costs. Trust income goes to charity for a specified number of years, and then the trust terminates and assets are distributed estate-tax free to family members.

Paying modest gift tax currently on property transferred to a family lead trust is often preferable to paying estate tax later on the appreciated values—even when the time value of money is taken into account. Further, the gift tax calculation is more advantageous because it is "tax exclusive." On the other hand, the estate tax calculation is "tax inclusive," using a base that includes all assets in the

gross estate, including those that will be used to pay the tax itself.

The grantor receives a gift tax charitable deduction for the present value of the family lead trust income expected to pass to charity. Paying some gift tax now on the non-charitable portion, and possibly settling difficult valuation problems during life, may be preferable to the personal representative negotiating (or perhaps litigating) valuation issues with the IRS later after values have increased and tax rules may have changed for the worse.

The value of the assets subject to the gift tax can be reduced further by using family limited partnership interests or closely held stock entitled to discounts. If minority-discount assets are used to fund a family lead trust, the nominal value of the trust for purposes of the federal gift tax liability is reduced even though the assets are still generating the same total return on the underlying property.

For example, if a 30% discount is applied to assets worth $20 million and generating an 8% return on investment (ROI), the nominal trust value is reduced to $14 million and the effective ROI is now 11.43%. With a lower nominal value, the trust assets can now support a 7.15% annuity payment to charity, thus generating a far lower gift tax liability than if the trust were valued at $20 million and paid a 5% annuity payment of $1 million per year to charity.

Excess earnings inside a family lead trust may be used to significantly leverage or increase the ultimate distribution to family members by including a sizable life insurance policy on the life of the grantor inside the trust. The generally tax-free insurance proceeds may also provide the liquidity needed to pay the estate tax on assets passing outside the trust.

Cautionary Note

Individuals and their advisors should take great care to establish and document the legitimate non-tax business purposes that lie behind the formation of the FLP (or, indeed, of any entity formed in similar circumstances). Individuals can reap real and substantial business benefits from an FLP such as streamlining, reducing management and other expenses, centralizing the flow of information and decision-making, and better monitoring the performance of various lines of business or investments.

The IRS is especially diligent in examining FLPs. A long series of FLP rulings and cases over the past two decades has outlined what is acceptable in the planning and execution of the FLP model [e.g., *Estate of Bongard*, 124 T.C. 95 (2005)].[24] Advisors should carefully observe and document the appropriate organizational and operational formalities in order to protect both business owner donors and their charitable recipients.

Limited Liability Companies

A limited liability company (LLC) is a statutory form of business entity authorized in all states that offers many of the advantages available to partnerships and corporations. The LLC usually offers the tax pass-through attributes of a partnership while providing the limited liability that ordinarily exists only with a corporation. Unlike a basic FLP, no one need be in the position of a general partner, exposed to unlimited liability. The LLC extends limited liability to all owners. In many states, the LLC offers the most flexibility of any business entity.

LLC interest holders are typically referred to as "members," their enterprise is governed by "Articles of Organization," and overall guidance is provided by a "manager" or "managers." It is possible that an LLC may even be a converted partnership that changed its form of organization to seek greater protection from liability. Such conversions may be made tax free.[25]

Unlike limited partners, LLC members may materially participate in management while continuing to enjoy limited liability. LLCs generally offer more flexibility and more favorable tax treatment than S corporations. In addition, the restrictions as to who can be permitted as an S shareholder do not apply to membership in an LLC.[26]

Charitable gifts of interests in LLCs are typically taxed (as are those of a partnership interest), but the donor must take care to verify the tax filing status of the LLC. The "check-the-box regulations" expanded access to other tax classifications (including the single-member disregarded entity).[27]

S Corporations

Corporations that have elected to be taxed as pass-through entities under subchapter S of the IRC are commonly referred to as S corporations.[28] The character of items of income, deductions, losses, and credits passes through to the shareholders.[29]

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, or charitable organizations exempt from income tax under IRC § 501(a)
- There must be only one class of stock issued and outstanding (for example, a corporation with both common and preferred stock would not be eligible).[30]

When a donor contributes S corporation stock held more than one year to a public charity, the donor generally receives a deduction for the fair market value of the stock and does not pay tax on any appreciation in the stock's value. However, the deduction must be reduced by the amount of gain that would have been ordinary income had the donor sold the stock.[31] An S corporation shareholder cannot deduct more than the shareholder's tax basis in the stock.

Furthermore, a charity that accepts a gift of S corporation stock will have its income or loss from the interest treated as unrelated business income that can be taxed—even if the S corporation business activity is passive and not active. And, when the charity sells the S corporation stock, the gain or loss may be treated as unrelated business taxable income.[32]

Funding a CLT with S Corporation Stock

Funding a Charitable Lead Trust (CLT) with S corporation stock can be difficult because a taxable trust cannot own S corporation stock.[33] However, careful planning can open possibilities for an S corporation shareholder interested in creating a CLT.

Grantor CLT: A private letter ruling stated that a grantor CLT can hold S corporation shares because the grantor constructively holds the shares.[34] The grantor will receive an income tax deduction for the fair market value of the stock, subject to valuation discounts. During the CLT term, the trust income is taxable to the grantor (even though the grantor doesn't actually receive the income). Finally, when the CLT terminates, the S corporation stock will be returned to the grantor.

One necessary precaution is to include a provision in the CLT agreement to convert the trust to a permitted S corporation shareholder in the event the grantor dies before the CLT is scheduled to terminate. Without such language, the S corporation may be disqualified when the CLT ceases to be a grantor trust.

Non-Grantor CLT: A non-grantor CLT is generally not permitted as an S corporation shareholder.[35] However, the CLT could qualify as an electing small business trust (ESBT) and hold such stock. To qualify, a CLT must meet the following strict requirements:

- All beneficiaries of the CLT must be living people, estates or charities.
- The S corporation stock must be gifted to the CLT (not bought).
- The CLT cannot be a qualified Subchapter S trust.
- The beneficiaries must all be considered shareholders of the S corporation.[36]

Funding a CRT with S Corporation Stock

Generally, a Charitable Remainder Trust (CRT) cannot be an S corporation shareholder because a CRT is not a qualified exempt organization under IRC § 501(c)(3); instead, a CRT obtains its tax-exempt status under IRC § 664. However, the IRS did issue Private Letter Ruling 9340043 that allowed an S corporation to establish a Charitable Remainder Unitrust (CRUT) with its shareholder as the non-charitable beneficiary.

The S corporation funded the CRUT with a partnership interest, but only after the partnership had been stripped of any assets that created ordinary income. When the partnership was liquidated—producing only capital gain income—the CRUT trustee could invest its share of the proceeds. The sole S corporation shareholder was the non-charitable beneficiary.

The IRS determined that the contribution of the partnership interest was considered appreciated long-term capital gain and could be deductible as such—and the deduction flowed through to the sole shareholder. The transfer of the partnership interest by the S corporation to the CRUT did not trigger capital gains taxation and the full value (including the untaxed appreciation) could grow within the CRUT. Plus, there was no incidence of UBTI in the CRUT.

Illustration

Planning and Drafting Considerations

Clearly, FLPs and LLCs offer advantages to holders of their shares which are not available to S corporation shareholders. Nonetheless, a gift of any type of appreciated business interest to a charitable recipient is likely to remain more advantageous than a gift of cash.

S Corporation*

1.	FMV	$100,000
2.	Basis	$20,000
3.	Capital Gains tax not paid	$12,000
4.	Tax value of deduction	$35,000
5.	Total savings (3 & 4)	$47,000
6.	Cost of gift	$53,000
	UBTI tax owed by charity	$27,650
	Total to charity	$72,350

Partnership*

1.	FMV	$100,000
2.	Basis	$20,000
3.	Capital Gains tax not paid	$12,000
4.	Tax value of deduction	$35,000
5.	Total savings (3 & 4)	$47,000
6.	Cost of gift	$53,000
	UBTI tax owed by charity	$-0-
	Total to charity	$100,000

LLC*

1.	FMV	$100,000
2.	Basis	$20,000
3.	Capital Gains tax not paid	$12,000
4.	Tax value of deduction	$35,000
5.	Total savings (3 & 4)	$47,000
6.	Cost of gift	$53,000
	UBTI tax owed by charity	$-0-
	Total to charity	$100,000

Gift of Cash*

1.	FMV	$100,000
2.	Basis	$20,000
3.	Capital Gain tax paid	$12,000
4.	Tax value of deduction**	$30,800
5.	Total savings	$30,800
6.	Cost of gift	$69,200
	UBTI tax owed by charity	$-0-
	Total to charity	$88,000

* A 35% income tax bracket has been used in making this comparison.

** 35% of $88,000

When the Charitable Inspiration Strikes

If, as Edison reportedly stated, "genius is 1% inspiration and 99% perspiration,"[37] the professional advisor may have to provide the 99% perspiration to make a client's charitable donation of a business interest work. Understanding the benefits, pitfalls and requirements of such gifts is the key to success. A well prepared advisor can help inspired clients reach their philanthropic goals and, in doing so, also further the goals of the selected charities.

Endnotes

1 Information from the Thomas Edison website: "http://www.thomasedison.com/quotes.html" www.thomasedison.com/quotes.html.

2 Treas. Reg. § 20.2031-1(b)]; IRC § 2701.

3 IRC § 170(f)(8)(A).

4 IRC §170(f)(11); Treas. Reg. §1.170A-13(b)(3)(i).

5 Treas. Reg. § 25.2512-3.

6 *Hendrix v. United States*, 2010 U.S. Dist. LEXIS 73999 (S.D. Ohio 2010).

7 Id at 10.

8 Id at 15.

9 Id at 22.

10 Defined in Treas. Reg. § 1.170A-13(c)(4).

11 IRC §170(f)(11); Treas. Reg. §1.170A-13(c)(1)(i); Treas. Reg. § 1.170A-13 (b)(2)(ii).

12 IRC § 170(f)(11)(E)(ii).

13 IRC §170(f)(11)(E)(iii).

14 IRC § 2703.

15 IRC § 2703(a).

16 IRC § 2703(b); Treas. Reg. § 25.2703(b).

17 *Mandelbaum v. Comm'r*, T.C. Memo 1995-255 (June 12, 1995).

18 Revenue Ruling 2004-5 (2004-3 IRB 295).

19 *Smith v. Comm'r*, TC Memo 2007-368 (Dec 17, 2007).

20 IRC § 732(a); Treas. Reg. § 1.732-1(a).

21 IRC § 132(b); Treas. Reg. §1.732-1(b).

22 IRC § 170(b) and (c), 1001 and 1011(b); Treas. Reg. §1.170A-4(c)(2).

23 *Goodman, et al v. U.S.*, 85 AFTR 2d 2000-438 (S.D. FL, 1999).

24 *Estate of Bongard v. Comm'r*, 124 T.C. No. 8, March 15, 2005.

25 Rev. Rul. 95-37, 1995-1 CB 130.

26 The S-corp restrictions are found in IRC §1361.

27 Treas. Reg. § 301.7701-1.

28 IRC § 1361.

29 IRC § 1366.

30 IRC § 1361(b).

31 IRC § 170(e).

32 IRC § 512(e).

33 IRC § 1361(b)(1)(B).

34 See PLR 199936031, PLR 199908002.

35 IRC § 1361(b)(1)(B).

36 IRC § 1361(e).

37 However, these may not be Edison's actual words. An interesting discussion on this can be found at the Quote Investigator website at: http://quoteinvestigator.com/2012/12/14/genius-ratio

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