

Why Family Businesses Should Consider Their Charitable Options and the Income Tax Advantages of “Doing Good”

*Advanced Income Tax Planning for
Family Business*

**Florida Bar Tax Law Section
October 14, 2016
Vinoy Renaissance St. Petersburg**

Robert G. Collins, CFA, President, NCF Tampa Bay

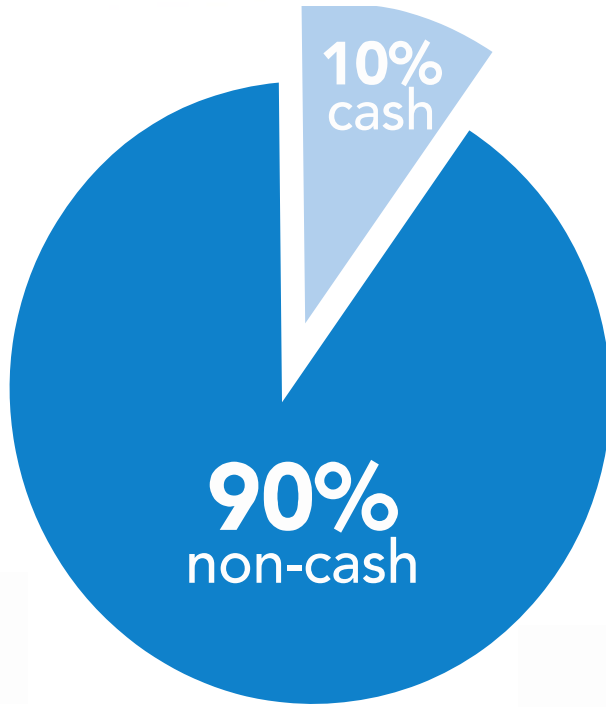
Cristin C. Keane, Esq., Shareholder, Carlton Fields, Tampa, FL

Jason E. Havens, Senior Counsel, Holland & Knight, Jacksonville, FL

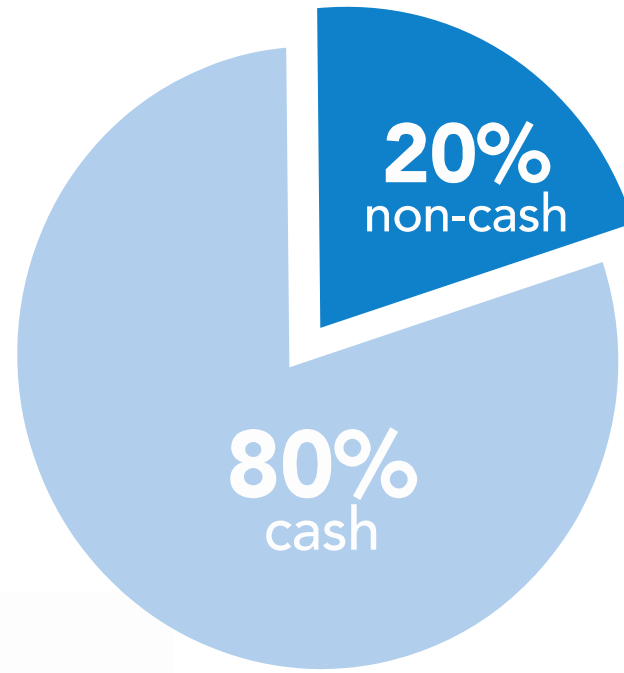


**National Christian
FOUNDATION**

The Problem with How We Give



What we have



What we give



Appropriate Assets for Consideration

Business Interests

- C Corporation stock
- S Corporation stock
- Partnership interests



Real Estate Assets

Tangible Personal Property



Maximizing Annual Charitable Deductions

Three distinct tax benefits

- Immediate (and maximum) charitable income tax deduction
- Reduced income tax liability on annual operating income with real estate and pass through entities
- Avoided / reduced income tax liability upon ultimate sale of business



The Charitable Deduction

Statutory Rules of the Game



IRC § 170 rules covered in white paper:

- Limitations on Gifts by Individuals (50/30/20% and 5 year carryover)
- Overall limit for C Corporations (10%)
- TPP (no reduction if exempt use)
- Gifts of Vehicles
- IP (basis)



Phase-out of Itemized Deductions

- Except for investment interest and casualty or theft losses, itemized deductions, including the charitable deduction, are subject to phase out. IRC § 68.
- Impact on the charitable deduction:
Primarily limited to states with no income tax or tax rates lower than the phase out percentage (3%).



Estate and Gift Tax Charitable Deduction

- IRC § 2055 allows an unlimited estate tax deduction for bequests to any charity
- IRC § 2522 permits unlimited gifts to be made to charity

to be best in any
point of view.
Charity ['tʃærə
generous action
help the needy
good deed in



Valuation Requirements

- Qualified appraisal, prepared by “qualified appraiser,” required for all non-liquid gifts valued in excess of \$5,000. Treas. Reg. § 1.170-13(c)(1).
- IRS Form 8283 must be attached to donor’s return. Prop. Treas. Reg. § 1.170A-16(d)(1)(iii).
- If gift exceeds \$500,000, qualified appraisal report must also be attached to return. Prop. Treas. Reg. § 1.170A-16(e).



Eligible Non-Liquid Assets for Charitable Gifting

- Publicly Traded Stocks and Bonds: Deduction is mean between highest and lowest quoted prices registered by exchange market on date of gift. Treas. Reg. §§ 2512-2(b)(1) and 20.2031-2(b)(1).
- Mutual Fund Shares: Deduction is public redemption price for units on date of gift, or last preceding date for which quoted redemption is available. Treas. Reg. §§ 25.2512-6(b)(1) and 20.2031-8(b)(1).
- Real Estate: Deduction is appraised FMV.



Privately & Closely Held Business Interests

- Classification of Business Entities for Federal Income Tax Purposes and the Limited Liability Company: “Check the box” regulations. Treas. Reg. §§ 301.7701-1 through 301.7701-3.
- SMLLCs and notion of “disregarded entity.” Rev. Proc. 2002-69, 2002-2 C.B. 831 and IRC § 761(f)).
- Tax Entity Classifications:
 - Proprietorships
 - Partnerships
 - Corporations (C and S corps)
 - Trusts



Three Planning Strategies for Charitable Gifts Utilizing Private and Closely Held Business Interests or Other Non-Liquid Assets

1. Give and Sell Strategy: Goal is to give before entering into binding agreement to sell to secure “double” tax benefits of (a) obtaining charitable income tax deduction to help offset gain realized by donor, while (b) avoiding, or at least significantly reducing, tax on proceeds to charity.
2. Give and Hold Strategy (“Charitable Shareholder”): Gifting income producing asset to be held by charity without contemplation of pending sale.
3. Gift by Business Entity of Underlying Asset: Closely held business entity makes gift of asset. May have advantages over business interest gift, especially with pass through entities.





The Give and Sell Strategy



National Christian
FOUNDATION

The Give and Sell Strategy

- For long term capital gain (LTCG) property, charitable income tax deduction equal to FMV of gifted interest, which first offsets higher taxed income
- Donor avoids tax on portion that was gifted prior to sale
- In many cases, charitable recipient will not pay any unrelated business income taxes (UBIT) upon subsequent disposition of asset or business interest
- For taxpayers who are potentially subject to “net investment income tax” (NIIT) on passive income under IRC § 1411, tax of 3.8% is not imposed on gain realized by charity



The Give and Sell Strategy

If non-liquid asset is private business interest, several other factors to assess in determining benefit of making charitable gift prior to sale:

- What type of business interest is being gifted?
- What is underlying nature of business?
- Is there any debt present in business entity?



The Give and Sell Strategy

Subchapter C Corporations

- **Donor:**

Receives charitable deduction equal to appraised value assuming LTCG asset, which offsets ordinary income plus gain

- **Charitable Recipient:**

- Stock Sale: Gain would generally fall into the capital gain exception to the UBTI rules; thus no tax
- Asset Sale:
 - A corporate level tax will be incurred at a rate of approximately 35%, plus any state income tax
 - Distribution to charity would most likely qualify as dividend or capital gain on liquidation, avoiding additional tax
 - Distribution to charity not subject to 3.8% NIIT



The Give and Sell Strategy

Partnership Interests

Gift of a partnership interest involves many other factors and considerations for donor

- Ordinary Income Assets or “Hot Assets”: Because these underlying assets are recognized under IRC § 751 as ordinary income, value of charitable gift must be reduced to extent of any gain attributable to “hot assets.” IRC § 170(e)(1)(A)-(B).
 - Most common types of hot assets include (1) unrealized accounts receivable, (2) appreciated inventory, and (3) depreciation recapture.
 - Note that amount of any reduction in donor’s charitable deduction is based not on value of these assets themselves, but only on any gain attributable to them.



The Give and Sell Strategy

Partnership Interests

Debt and Bargain Sale Treatment to Donor

- Debt at partnership level is attributable to partner.
IRC § 752(d)
- Value of charitable gift must be reduced by amount of allocable debt to donor/partner
- Charitable gift of partnership interest with partnership debt also results in “bargain sale” treatment on transfer.



The Give and Sell Strategy

Partnership Interests

Impact on Charity: Potential for UBTI under IRC § 511

- Capital Gain: Exception for capital gains from UBTI rules generally applies, regardless of whether ownership interest in partnership is sold, or whether underlying assets of partnership are sold.
- Hot Assets: Portion of any gain attributable to “hot assets” will likely constitute UBTI.
- Unrelated Debt Financed Income: Partner, including a charity, is treated as owning a pro-rata interest in each partnership asset and liability. Thus, any acquisition indebtedness of partnership will constitute UDFI under IRC § 514, which is taxed as UBTI.



The Give and Sell Strategy

Subchapter S Corporations

Hot Assets: Impact on Donor's Deduction

IRC § 170(e)(1)(B) states, “[f]or purposes of applying this paragraph in the case of a charitable contribution of stock in an S corporation, rules similar to the rules of section 751 shall apply in determining whether gain on such stock would have been long-term capital gain if such stock were sold by the taxpayer.”



The Give and Sell Strategy

Subchapter S Corporations

UBTI: Impact on the Charity

All income to charity owning S corporation stock, whether allocable as shareholder or gain from sale of stock, is treated as unrelated business taxable income (UBTI) to the charity. IRC § 511(e)(1). Thus, gain resulting from sale following gift to charity - otherwise exempt from taxation – will result in UBTI (taxed at capital gain rates).



The Give and Sell Strategy

Subchapter S Corporations

UBTI: Impact on the Charity

Because all income derived from S corporations, including capital gain on sale following gift, is considered UBTI for charities, some organizations have established their own supporting organizations under IRC § 509(a)(3), organized as trusts to take advantage of 50% charitable deduction available to trusts under IRC § 512(b)(11).



The Give and Sell Strategy

Subchapter S Corporations

Impact of IRC §§ 1367 and 1377

- Income allocated on a per diem bases: IRC § 1377(a)(1).
- Basis follows stock: Treas. Reg. § 1.1376-1(d)(1).
- Options to terminate tax year:
 - IRC § 1377(a)(2) [Entire Interest]
 - Treas. Reg. § 1.1368-1(g) [20% within 30 days]



The Give and Sell Strategy

Proprietorships

Impact on Donor

- Charitable Deduction
 - Gift of an interest in a proprietorship to charity must have the value reduced by any ordinary income items included in the valuation, and
 - the presence of debt will in most instances trigger gain as a bargain sale
 - Creation of Partnership. If a donor retains any interest in the business, a partnership with the charity will result



The Give and Sell Strategy

Proprietorships

Impact on Charity

With creation of partnership (i.e., with addition of charity), all potential tax implications to charity as partner will apply for period prior to sale, as well as upon sale of either assets or entity.



A blue background with a grid pattern, overlaid with large green numbers '41.13' and red numbers '-0.76', suggesting a financial market or stock exchange theme.

The Give and Hold Strategy



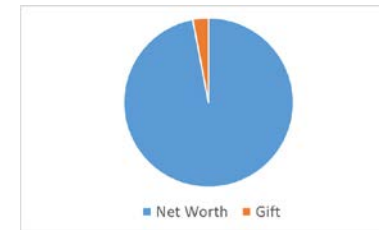
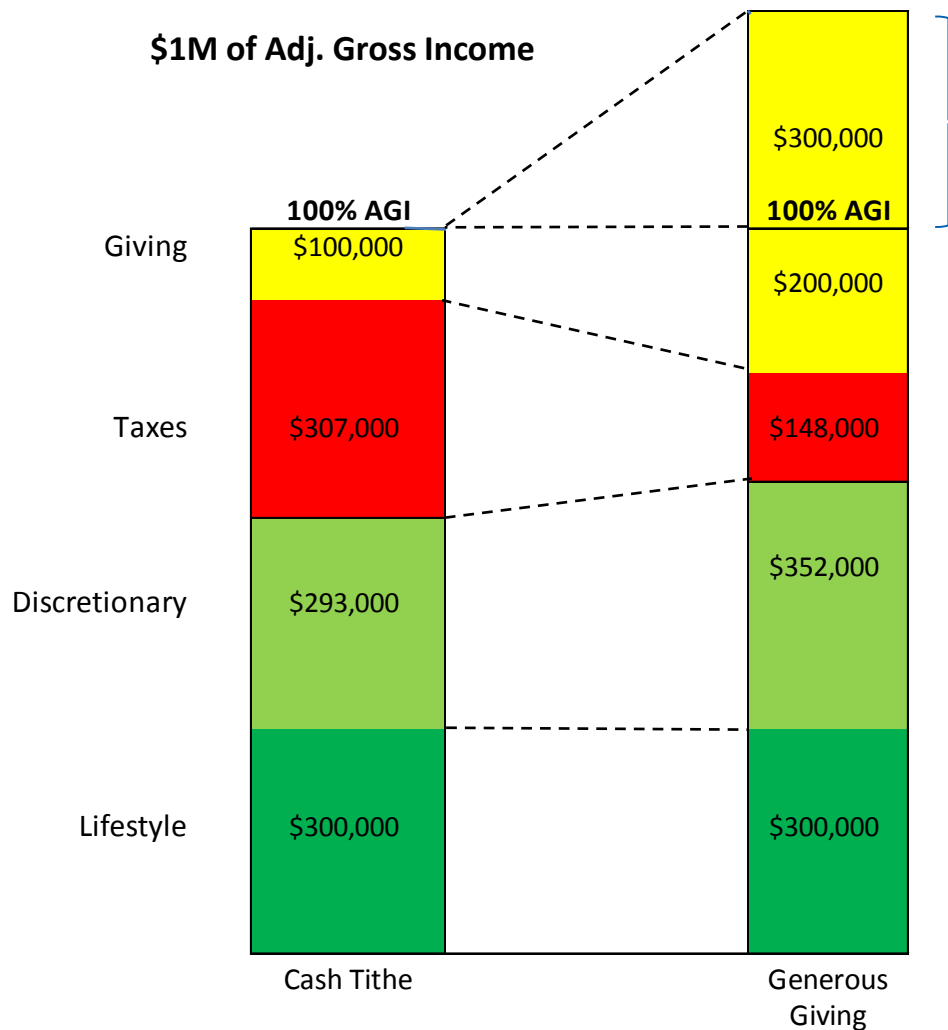
National Christian
FOUNDATION

The Give and Hold Strategy

- For purposes of analyzing charitable deduction implications for donor of gift of non-liquid asset; or gift of interest in C corporation, S corporation, or partnership, analysis discussed above regarding gift in contemplation of sale will apply.
- Charity will now be partner or shareholder in enterprise or business, effectively receiving interest in income that donor would have previously received and paid tax on.
- Income received by charity may be subject to UBIT.



The Give and Hold Strategy



Illustration

Non-cash gift to NCF Giving Fund

- Private equity
- Real estate
- Minerals
- Public securities

Cash Gift 20% (Note: this amount is generated by repeated giving of the tax savings from the Non-Cash Gift, + cash tithe)

A generous giver may give 50% of AGI, live on 30% or so of AGI, and pay tax of <20% of AGI instead of paying tax of >30% of AGI



The Give and Hold Strategy

Tax Classification of Privately Owned Businesses: Application of UBIT rules varies significantly depending on underlying nature of business entity held by charity:

- Subchapter C Corporations: C corporations generally do not subject charity to UBIT, and any distributions from corporation to charitable shareholders are exempt from UBIT under exception for dividends. Furthermore, any gain realized on sale of C corporation stock is capital gain, and also not considered UBTI.
- Subchapter S Corporations. Because of IRC § 511(e)(1), all flow-through income reportable to charity is treated as UBTI, even though characterization of income item might have otherwise been excluded from UBTI, such as rent from real estate.
- Partnerships: Income from UBTI-exempt sources, such as interest, dividends, capital gains, etc., retain same character as if such income were realized directly from source from which realized by partnership, or incurred in same manner as incurred by partnership. IRC § 702(b). Therefore, charitable owner's distributive share of these sources of income is exempt from UBIT as well.



The Give and Hold Strategy

Statutory Exemptions from UBIT:

- Dividends, interest and annuities (IRC § 512(b)(1))
- Royalties (IRC § 512(b)(2))
- Rental income from real property (IRC § 512(b)(3)(A)(i))
- Capital gain on sale of appreciated capital assets (IRC § 512(5))





Gift by Business Entity of Underlying Assets



National Christian
FOUNDATION

Gift by Business Entity of Underlying Assets

Third potential gifting strategy is for business entity to make gift of underlying asset(s).

- Generally not attractive option for C corporation due to relatively small deduction threshold and inability of individual shareholders to benefit from tax deduction.
- Thus mostly used by pass through entities.



Gift by Business Entity of Underlying Assets

Partnerships

Charitable gifts of non-liquid assets made by partnership are reported as separate item proportionately to each partner. IRC § 701(a)(4).



Gift by Business Entity of Underlying Assets

Partnerships

- Charitable gifts of non-liquid assets made by partnership reported as separate item proportionately to each partner. IRC § 701(a)(4).
- Basis Adjustment: In absence of statutory authority, IRS has ruled that partners only have to reduce basis in their partnership interests by proportionate amount of adjusted basis in property gifted. Rev. Rul. 96-11, 1996-1 C.B. 140.



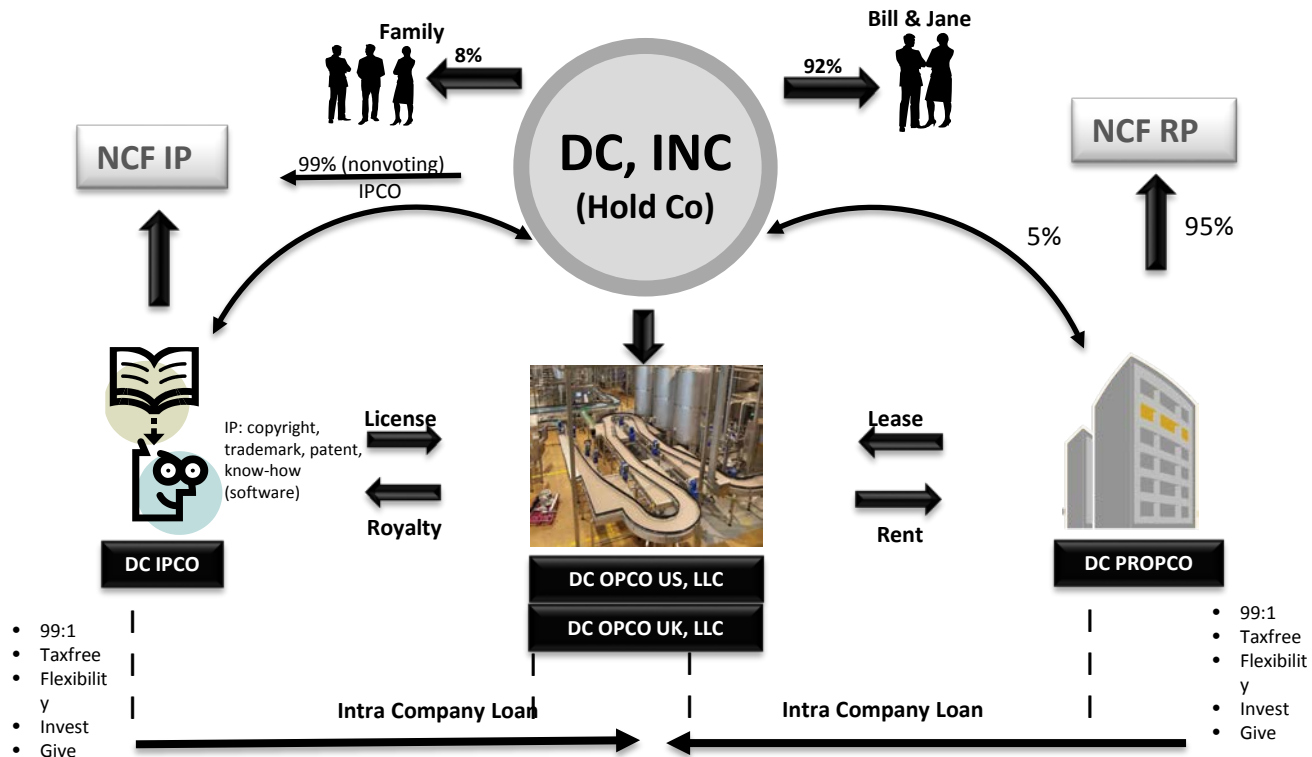
Gift by Business Entity of Underlying Assets

S Corporations

- S corporations report separately various items that could affect tax liability of any individual shareholder, specifically cross referencing partnership rules regarding separate reporting of charitable deductions. IRC § 1366(a)(1).
- Basis Adjustment: In 2006, IRC § 1367(a)(2) was added to allow shareholders of S corporations making charitable contributions to reduce stock adjusted basis by proportionate share of gifted property's adjusted basis. IRC § 1367(a)(2). Provision permanently extended in 2015.



Subsidiary Structure





Other Planning Considerations and Issues



National Christian
FOUNDATION

Other Planning Considerations and Issues

Prenarranged Sale:

When sale of business is expected to occur in close proximity to charitable gift of interest in business, care must be taken to ensure gift is consummated before legally binding agreement to sell business has been executed. Otherwise, transaction is open to challenge by IRS asserting that gift was not made prior to sale and with gain being fully recognized.



Other Planning Considerations and Issues

Pearranged Sale:

Tax Court addressed issue in *Palmer v. Comm'r*, 62 T.C. 684 (1974), holding:

The tax consequences to the donor turn on which path he chooses, and so long as there is substance to what he does, there is no requirement that he choose the more expensive way. [Citing the Supreme Court in *Gregory v. Helvering*, [35-1 USTC ¶9043], 293 U.S. 465 (1935)].



Other Planning Considerations and Issues

Preadarranged Sale:

IRS subsequently acquiesced in *Palmer* decision, stating:

The Service will treat the proceeds as income to the donor under facts similar to those in the *Palmer* decision only if the donee is legally bound, or can be compelled by the corporation, to surrender the shares for redemption. Rev. Rul. 78-197, 1978-1 C.B. 83 (emphasis added).



Other Planning Considerations and Issues

Excess Business Holdings:

Rules regarding “excess business holdings” (“EBH”), IRC § 4943, were enacted as part of Tax Reform Act of 1969 applying to private foundations. Provisions on EBH are primarily focused on discouraging concentrated holdings of business interests by charity, specifically private foundations.

Rules were extended to donor advised funds in 2006 upon enactment of Pension Protection Act.

Covered in more detail in white paper.





Defending the Charitable Deduction:

**Valuation and Substantiation Rules
Applicable to Non-Liquid Assets**



National Christian
FOUNDATION

Cash Gifts

Less than \$250:

- Bank record or written acknowledgment from charity

Equal to or Greater than \$250:

- Written acknowledgment
- State amount of gift
- State if any goods or services were provided
- Estimate of value of goods or services
- Donor receives prior to filing return



Non-Cash Gifts

Qualified Appraisal for Gifts over \$5,000

- Prepared not more than 60 days before gift
- Not later than return due date (with extensions)
- Signed by “qualified appraiser”
- Property described
- Qualifications of appraiser
- Method and basis of valuation
- Form 8283



Non-Cash Gifts

Gifts over \$500,000

Appraisal must be attached



Judicial and Administrative Enforcement: Common Issues

- Statement on “goods or services” absent from acknowledgement
- Incomplete appraisal summary
- Wrong asset appraised! (e.g., stock v. corporate asset)
- Missing written acknowledgement
- Untimely appraisal
- Incorrect appraisal method
- Lack of proof (e.g., blank signed acknowledgement)



Philanthropic Planning

Why Family Businesses Should
Consider Their Charitable Options
and the Income Tax Advantages of
“Doing Good”:

Questions?



© 2016 NATIONAL CHRISTIAN FOUNDATION

NOTE: This information is designed to provide accurate and authoritative information in regard to the subject matters covered. It is published with the understanding that in this information, the authors are not engaged in rendering legal, accounting, or other professional services. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

(From a Declaration of Principles jointly adopted by a committee of the American Bar Association and a committee of Publishers and Associations.)

