CHARITABLE PLANNING
WITH CLOSELY-HELD BUSINESS INTERESTS

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Charitable gifts involving some kind of closely-held business entity are becoming an increasingly important element of an overall estate plan. They can be an effective tool to maximize the benefits of valuation discounts, reduce income and estate taxes, and generally promote a donor's estate planning and philanthropic goals. But it is important to understand the unique tax and other implications of the gift from the perspectives of the donor, the donee, and the closely-held business entity. It is equally important to plan for the ultimate disposition of the business interest—will the charity hold the interest long-term, or should the plan include an appropriate "exit strategy"? The purpose of this outline is to provide something of a primer on the basic issues, and some "food for thought" on some interesting planning ideas.

I. CHARITABLE GIFTS OF CLOSELY-HELD BUSINESS INTERESTS GENERALLY.

A. Valuation. Noncash gifts are generally valued at "fair market value," raising familiar problems of determination of value. Aggressive or fraudulent valuations of charitable contributions have been a problem since enactment of the first charitable deduction in 1917. Traditionally most of the reported decisions involved charitable gifts of artwork. As noted by the judge in a 1984 Tax Court overvaluation case (not involving a charitable contribution), "after examining some of the paintings, we feel obliged to note that we refer to them as artwork merely for convenience." *J.S.M. Enterprises v. Commissioner*, 48 T.C.M. 138 (1984). Recent audit data, however, confirms that the valuation of charitable gifts of business interests is the subject of increasing IRS scrutiny.

1. Burden of Proof. As in most valuation disputes, the donor has the burden of proof in a charitable deduction case. *Welch v. Halvering*, 290 U.S. 111 (1933); *Lamphere v. Commissioner*, 70 T.C. 391 (1978). See also *Holtzman*, 40 T.C.M. 350 (1980).

2. Valuation Penalties.

(a) Substantial Valuation Misstatement. The "accuracy-related" penalties of IRC section 6662 apply to charitable contributions. There is a 20 percent penalty on any underpayment of tax (in excess of $5,000) resulting from a "substantial valuation misstatement" – if the value or tax basis of any property claimed on an income tax return is 150 percent or more of the correct amount (or stated another way, if the correct value is two-thirds or less of the claimed value). IRC § 6662(e)(1)(A). (Before enactment of the Pension Protection Act of 2006 ("PPA 2006"), generally effective for returns filed after August 17, 2006, the threshold was 200 percent (i.e., if the correct value is 50 percent or less of the claimed value).)

(b) Gross Valuation Misstatement. The penalty increases to 40 percent on any underpayment of tax (in excess of $5,000) resulting from a "gross valuation misstatement" – if the reported value or basis is 200 percent or more of the correct amount (i.e., if the correct value is 50 percent or less of the claimed value). IRC § 6662(h). (Before PPA 2006, the threshold was 400 percent (i.e., if the correct value is 25 percent or less of the claimed value).)

(c) Other Taxpayer Penalties. Fraud penalties of 75 percent can be imposed on any underpayment of tax attributable to fraud. IRC § 6663. Criminal penalties are also possible. IRC §§ 7206 and 7207.

(d) Reasonable Cause Exception. Most underpayment penalties provide a general exception if the taxpayer can show "reasonable cause" and "good faith." IRC § 6664(c)(1). The exception is completely inapplicable, however, to "gross" overvaluations of "charitable deduction property" (property for which a charitable deduction is claimed), and to "substantial" overvaluations unless the donor can demonstrate that (1) the claimed value of the property was based on a "qualified appraisal made by a qualified appraiser" and (2) the donor made a "good faith investigation of the value of the contributed property." IRC § 6664(c)(3).

(e) Appraiser Penalties. There are also penalties for appraisers who value property at a value that is 150 percent or more than the correct value (i.e., subject to either of the valuation misstatement penalties) if the appraiser knows, or reasonably should have known, that the appraisal would be used in connection with a tax return. IRC § 6695A(a). The amount of the penalty is the greater of 10 percent of the underpayment or $1,000, but with a maximum of 125 percent of the appraisal fee received by the appraiser. IRC § 6695A(b). There is an exception if the appraiser can establish to the satisfaction of the IRS that the appraised value was "more likely than not the proper value" (whatever that means). IRC § 6695(c).

B. Substantiation.

1. Generally. On several occasions since 1982, Congress has imposed increasingly stringent rules for the verification and reporting of charitable contributions. In most cases, the penalty for noncompliance is the complete disallowance of an income tax charitable deduction. (There are no comparable requirements for the gift and estate tax charitable deductions, but the donor must submit such data as may be requested by the IRS. Treas. Reg. §§ 20.2055-1(c) and 25.2522(a)-1(c).) Separate rules exist for cash contributions, contributions of property with a value of less than $500, contributions of property with a value of less than $5,000, contributions of property with a value in excess of $5,000, contributions of artwork with a value in excess of $20,000, and contributions with a value in excess of $500,000.

2. Receipt Requirement. Since 1993, no charitable deduction is allowable for any contribution of cash or other property with a value of $250 or more unless the donor obtains a "contemporaneous written acknowledgement" from the donee organization, regardless of how reliable the donor's records otherwise may be. IRC § 170(f)(8)(A). The required acknowledgment must (a) describe the cash or other property contributed (but not the value of noncash property) and the date of contribution and (b) include either (i) a good faith estimate of any goods or services provided in connection with the gift or (ii) a statement that no goods or services were provided. IRC § 170(f)(8)(B). The acknowledgement must be received by the donor before the earlier of (a) the date of filing the donor's tax return claiming the deduction or (b) the due date (including extensions) for filing the return. IRC § 170(f)(8)(C). This is rarely a problem in the case of gifts to public charities, which generally issue acceptable receipts as a matter of course, but the Service does not take kindly to receipts that do not contain all essential information required by the statute (see, e.g., *Durden v. Commissioner*, T.C. Memo. 2012-140 (2012); *DiDonato v. Commissioner*, T.C. Memo. 2011-153 (2011)).

   (a) This rule applies to gifts to private foundations, even to trust-form private foundations of which the donor is the sole trustee. Compliance with the rule in this case would thus literally require the donor as trustee to give a receipt to him or herself.

   (b) In the case of charitable gifts by S Corporations or partnerships, the entity is treated as the taxpayer for substantiation purposes, so the shareholder or partner is not required to obtain any additional substantiation for his or her share of the contribution. Treas. Reg. § 1.170A-13(f)(15).

   (c) The receipt requirement does not apply to gifts to charitable remainder trusts, but it does apply to transfers to pooled income funds. Treas. Reg. § 1.170A-13(f)(13).

3. Appraisal Requirements. Section 155 of the Tax Reform Act of 1984 imposed new procedures for verification and substantiation of contributions of property (other than cash or most publicly traded securities) with a claimed value of more than $5,000. Section 155 was not made a part of the Internal Revenue Code, but rather merely directed the Secretary of the Treasury to prescribe regulations. The basic requirements are now codified in IRC sections 170(f)(11)(C), (D), and (E). Under these substantiation rules, the donor must obtain a "qualified appraisal" of the contributed property from a "qualified appraiser," and attach an "appraisal summary" (IRS Form 8283) to the income tax return claiming a charitable deduction. Treas. Reg. § 1.170A-13(c)(2). Treasury issued long-awaited new regulations on June 30, 2018, generally applicable to gifts made after July 30, 2018, but the new "qualified appraisal" rules apply only to contributions made after January 1, 2019.

(a) The $5,000 threshold for property gifts subject to the appraisal requirement is determined on an annual basis, and the donor must take into account all gifts of the same or "similar" items and property donated during the year, whether or not donated to the same organization. Treas. Reg. § 1.170A-13(c)(1)(i). Gifts of cash or publicly traded securities are not subject to the appraisal rules, and a limited exception exists for gifts of non-publicly traded stock if the deduction involved is less than $10,000. Treas. Reg. § 1.170A-13(c)(2)(ii).

(b) The appraisal rules apply to gifts by individuals, partnerships, and most corporations. Treas. Reg. § 1.170A-13(c)(1)(i).

(c) The appraisal must be made no earlier than 60 days before the date of contribution and no later than the due date (including extensions) of the return on which the charitable deduction is claimed. Treas. Reg. § 1.170A-13(c)(3)(i).

(d) The appraisal must be received by the donor on or before the due date (including extensions) of the return on which the deduction is first claimed or reported, or in the case of a deduction first claimed on an amended return, the date the return is filed. Treas. Reg. § 1.170A-13(c)(3)(iv)(B).

(e) Under the new regulations, a "qualified appraisal" is an appraisal that is prepared by a qualified appraiser in accordance with "generally accepted appraisal standards," which is defined as "the substance and principles of the Uniform Standards of Professional Appraisal Practice, as developed by the Appraisal Standards Board of the Appraisal Foundation." Treas. Reg. § 1.170A-17(a)(2).

(f) The regulations (section 1.170A-17(a)(3)) require that a "qualified appraisal" must contain a variety of detailed information (including items not generally included in appraisals), including <u>all</u> of the following:

- A description of the property in sufficient detail for a person who is not generally familiar with the type of property to ascertain that the property that was appraised is the property that was (or will be) contributed;
- In the case of tangible property, the condition of the property;
- The "valuation effective date" (i.e., the date to which the value opinion applies, which must be no earlier than 60 days before the date of contribution and no later than the date of contribution);
- The terms of any agreement that restricts the donee's right to use or dispose of the property, reserves to or confers

upon any person the right to the income from or possession of the property (such as charitable remainder trusts, pooled income funds, and charitable gift annuities), or earmarks the property for a particular use;

- The date (or expected date) of the contribution;
- The name, address, and taxpayer identification number of the appraiser and the appraiser's employer (if any);
- The appraiser's qualifications to value the type of property being valued, including the appraiser's education and experience;
- The signature of the appraiser and the date signed by the appraiser;
- The following declaration by the appraiser: "I understand that my appraisal will be used in connection with a return or claim for refund. I also understand that, if there is a substantial or gross valuation misstatement of the value of the property claimed on the return or claim for refund that is based on my appraisal, I may be subject to a penalty under section 6695A of the Internal Revenue Code, as well as other applicable penalties. I affirm that I have not been at any time in the three-year period ending on the date of the appraisal barred from presenting evidence or testimony before the Department of the Treasury or the Internal Revenue Service pursuant to 31 U.S.C. 330(c)."
- A statement that the appraisal was prepared for income tax purposes;
- The date (or dates) on which the property was appraised;
- The appraised fair market value of the property on the date (or expected date) of contribution;
- The method of valuation used to determine the fair market value, such as the income approach, the market-data approach, or the replacement-cost-less-depreciation approach; and
- The specific basis for the valuation, such as specific comparable sales transactions or statistical sampling, including a justification for using sampling and an explanation of the sampling procedure employed.

(g) An appraisal is not a qualified appraisal for a particular contribution, even if all the requirements are met, if the donor either failed to disclose or misrepresented facts, and a reasonable person would expect that this failure or misrepresentation would cause the appraiser to misstate the value of the contributed property. Treas. Reg. § 1.170A-17(a)(6).

(h) The fee for a qualified appraisal cannot be based to any extent on the appraised value of the property. For example, a fee for an appraisal will be treated as based on the appraised value of the property if any part of the fee depends on the amount of the appraised value that is allowed by the Internal Revenue Service after an examination. Treas. Reg. § 1.170A-17(a)(9).

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

4. <u>Substantial Compliance</u>. The penalty for noncompliance with the qualified appraisal rules is the complete disallowance of a charitable deduction.

(a) Some taxpayers have successfully argued substantial compliance (see, e.g., *Consol. Investors Grp. v. Commissioner*, T.C. Memo. 2009-290 (2009); *Bond v. Commissioner*, 100 T.C. 32 (1993)), but most of the reported decisions have required strict compliance. See, e.g., *Scheidelman v. Commissioner*, T.C. Memo. 2010-151 (2010); *Henry R. Lord v. Commissioner*, T.C. Memo. 2010-96 (2010); *Friedman v. Commissioner*, T.C. Memo. 2010-45 (2010); *Hewitt v. Commissioner*, 109 T.C. 258 (1997), aff'd 166 F.3d 332 (4th Cir. 1998); *D'Arcangelo v. Commissioner*, T.C. Memo. 1994-572 (1994). In one recent case that made national headlines, a taxpayer donated real property worth more than $18.5 million but failed to meet the (very) technical qualified appraisal requirements. The Tax Court denied the claimed charitable deduction entirely. *Mohamed v. Commissioner*, T.C. Memo. 2012-152 (2012).

(b) Furthermore, taxpayers who fail to strictly comply with the substantiation rules have been assessed negligence penalties (see, e.g., *Olson v. Commissioner*, T.C. Memo. 2004-197 (2004)), accuracy-related penalties (see, e.g., *Friedman v. Commissioner*, T.C. Memo. 2010-45 (2010)), and even fraud penalties (*Manning v. Commissioner*, T.C. Memo. 1993-127 (1993) (taxpayer claimed nonexistent charitable deductions)).

(c) A recent Court of Appeals case illustrates the very limited scope of any "substantial compliance" arguments and the importance of complying with <u>all</u> the qualified appraisal rules.

- Facts: In March 2002, RERI Holdings I LLC purchased an asset (a complicated remainder interest in real property) for the sum of $2,950,000. On August 27, 2003, RERI contributed the property to charity, and subsequently claimed an income tax charitable deduction on its 2003 income tax return in the amount of $33 million. Apparently RERI obtained the required "qualified appraisal" of the property, but on the "appraisal summary" (IRS Form 8283) attached to the return failed to show any amount in the box provided for "Donor's cost or other adjusted basis." As a result, the IRS was not alerted to the fact that RERI paid less than $3 million to purchase the property in 2002 and claimed a $33 million charitable deduction for a gift less than 17 months later. The IRS disallowed the deduction for failure to comply with the applicable substantiation requirements.

- In RERI Holdings I LLC (149 T.C. 1 (2017)), the United States Tax Court held that the taxpayer was not entitled to a charitable deduction based solely on its failure to report its income tax basis in the donated property. The Tax Court emphasized that RERI's omission of its income tax basis on the IRS Form 8283 prevented the appraisal summary from achieving its intended purpose – disclosure of the purchase price "would have alerted [the IRS] to a potential overvaluation of the [donated property]."

- Although not mentioned by the Tax Court, the regulations provide that if a taxpayer "has reasonable cause for being unable to provide" adjusted basis information, the deduction will not be disallowed if the donor attaches "an appropriate explanation" to the appraisal summary. Treas. Reg. § 1.170A-13(c)(4)(iv)(C)(1). RERI did not do so.

- On May 24, 2019, the United States Court of Appeals for the District of Columbia affirmed the decision of the Tax Court, fully denying the charitable deduction. *Jeff Blau, Tax Matters Partner for RERI Holdings I LLC v. Commissioner*, 924 F.3d 1261 (CA Dist. Col. 2019).

- RERI argued to the Court of Appeals that it had substantially complied with the applicable rules, and that the Tax Court ruling "conflicts with … its prior holdings in *Dunlap v. Com'r*, 103 T.C.M. (CCH) 1689 (2012)." In that case, the court excused the petitioner's failure to report its basis on Form 8283, on the theory that supplying the basis was not "necessary to substantially comply with the Instructions." The Court of Appeals also rejected this argument, noting that (1) the *Dunlap* decision was a non-binding memorandum opinion and (2) the Tax Court's statement as to substantial compliance related only to the reasonable cause and good-faith exception to the accuracy-related penalties, as opposed to the mandatory substantiation rules at issue in RERI.

(d) The holding in *Durden v. Commissioner*, T.C. Memo. 2012-140 (2012), which dealt with the fundamental "contemporaneous written acknowledgement" requirement, may have been particularly harsh. In that case, the taxpayers made a $25,000 cash contribution to their church and received a letter from the church acknowledging the contribution, but the letter did not include the required statement that no goods or services were provided in consideration of the contribution. The Service disallowed the deduction entirely. The taxpayers argued substantial compliance at the Tax Court, but the court disagreed, explaining that the "no goods or services" statement was necessary to determine the deductible amount of the contribution.

5. Donee Reporting. The qualified appraisal rules also include a requirement designed to uncover subsequent dispositions by the donee organization at a market price lower than appraised value. Under this rule, if the contributed property is sold, exchanged, consumed, or otherwise disposed of by the donee within three years after the date of contribution, the donee must file an information return (IRS Form 8282) disclosing the facts of the transaction. IRC § 6050L.

C. Private Foundation Rules.

1. Generally. Private foundations (within the meaning of IRC section 509) and some split-interest trusts (within the meaning of Section 4947) are subject to the so-called "private foundation rules" of IRC sections 4941 to 4945. These rules can impose "excise taxes" as high as 200 percent of the amount involved in the prohibited transaction, so as a practical matter, they are more in the nature of absolute prohibitions than mere taxes. Briefly stated, sections 4941 to 4945 impose punitive taxes on foundations, foundation managers, and "disqualified persons" involved in the following:

- Acts of "self-dealing" (IRC § 4941) (see discussion below);
- Failure to make qualifying grants of at least a designated amount each year, generally equal to 5 percent of the private foundation's assets (IRC § 4942);
- "Excess business holdings" (IRC § 4943) (see discussion below);
- High risk or "jeopardy" investments (IRC § 4944); and
- "Taxable expenditures," including grants for impermissible purposes, certain grants to individuals, certain grants to foreign organizations, and certain grants to other private foundations (IRC § 4945).

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

2. Application to Charitable Remainder Trusts. The restriction against self-dealing applies to charitable remainder trusts. IRC § 4947(a)(2). The restrictions against excess business holdings and jeopardy investments apply only if the designated income beneficiaries include charitable organizations. IRC § 4947(b)(3). See also PLR 9210005.

3. Application to Charitable Lead Trusts. The restriction against self-dealing applies to charitable lead trusts. IRC § 4947(a)(2). The restrictions against excess business holdings and jeopardy investments apply only if the present value of the charitable income interest exceeds 60 percent of the aggregate fair market value of trust assets on the date of creation. IRC § 4947(b)(3).

D. Self-Dealing.

1. General Rule. The self-dealing rules effectively prohibit almost any business or other transaction between the foundation and a donor, members of the donor's family, or other "disqualified persons" within the meaning of IRC section 4946, generally including sales, exchanges, leases, loans, payment of compensation, or the furnishing of goods or services. See IRC § 4941. The prohibition is absolute and generally without regard to any consideration paid, and presently the Internal Revenue Service has no equitable authority to excuse harmless violations.

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

- The personal representative or trustee either:
  - Has a power of sale with respect to the property,
  - Has the power to reallocate the property to another beneficiary, or
  - Is required to sell the property under the terms of any option subject to which the property was acquired by the estate or trust;
- Such transaction is approved by the court having jurisdiction over the estate or trust (or the foundation);

- Such transaction occurs before the estate is considered terminated for federal income tax purposes, under the rules of Treasury Regulation section 1.641(b)-3 (or in the case of a revocable trust, before it is considered subject to IRC section 4947);

- The estate or trust receives an amount that equals or exceeds the fair market value of the foundation's interest or expectancy in such property at the time of the transaction, taking into account the terms of any option subject to which the property was acquired by the estate (or trust); and

- The transaction either:

    - Results in the foundation receiving an interest or expectancy at least as liquid as the one it gave up,

    - Results in the foundation receiving an asset related to the active carrying out of its exempt purposes, or

    - Is required under the terms of any option which is binding on the estate (or trust).

Treas. Reg. § 53.4941(d)-1(b)(3).

3. Indirect Self-Dealing. The probate exception is an exception to "indirect self-dealing." IRC section 4941 in effect prohibits acts of self-dealing, and the regulations under section 4941 expand that prohibition to apply to "any direct or indirect transaction." The term is not defined anywhere in the Internal Revenue Code or Treasury Regulations. The basic purpose of the indirect self-dealing rules is to prevent a private foundation and disqualified persons from engaging in a transaction that would otherwise be self-dealing by using an entity "controlled" by the foundation. For purposes of this rule, an organization is treated as controlled by a private foundation if the foundation or one or more of its foundation managers may, only by aggregating their votes or positions of authority, require the organization to engage in a transaction which if engaged in with the private foundation would constitute self-dealing. Treas. Reg. § 53.4941(d)-1(b)(5).

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

- The corporation offers to all the shareholders the opportunity to redeem "all the securities of the same class * * * subject to the same terms and conditions";

- The redemption offer constitutes a "bona fide offer" to redeem from all the shareholders; and

- The redemption price is "no less than fair market value."

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

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

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

   (a) In the case of donor advised funds, the term "excess benefit transaction" includes any "grant, loan, compensation, or similar payment" from the fund to donors, fund advisors, or a very broad variety of other disqualified persons. IRC § 4958(c)(2). PPA 2006 also added excise taxes on a variety of noncharitable and other "taxable distributions," and on distributions resulting in more than an "incidental benefit" conferred upon a donor, fund advisor, or other disqualified person. IRC §§ 4966 and 4967.

   (b) In the case of supporting organizations, the term "excess benefit transaction similarly includes any "grant, loan, compensation, or similar payment" from the organization to substantial contributors, members of the family of a substantial contributor, or a very broad variety of other disqualified persons. IRC § 4958(c)(3).

E. Excess Business Holdings.

1. General Rule. The purpose of the excess business holdings rule, like the purpose of the unrelated business income tax, is to prevent tax-exempt organizations from competing unfairly with taxable businesses. Under IRC section 4943, a private foundation is permitted to hold only very limited interests in an unrelated business enterprise. With respect to an incorporated business enterprise, the general rule is that a private foundation and all disqualified persons together may not own more than 20 percent of the voting stock, but this limit is raised to 35 percent if a third person has effective control of the business. IRC § 4943(c). Nonvoting stock is permitted, but only if all disqualified persons together

do not own more than 20 percent of the voting stock. IRC § 4943(c)(2). Similar rules exist for partnerships, joint ventures, and limited liability companies. No holdings are permissible in the case of a business enterprise operated in proprietorship form. IRC § 4943(c)(3).

(a) The excess business holdings rules apply to ownership in a "business enterprise." That term does not include a trade or business which is not an "unrelated" trade or business (as defined in IRC section 513). IRC § 4943(d)(3)(A).

(b) The term "business enterprise" also excludes any trade or business at least 95 percent of the gross income of which is derived from "passive sources." IRC § 4943(d)(3)(B).

(c) These exceptions are consistent with Congress's intent to prevent tax-exempt organizations from competing unfairly with taxable businesses, but to permit tax-exempt organizations to engage in passive investment activities.

2. Application to Donor Advised Funds and Supporting Organizations. Since enactment of PPA 2006, the restrictions on excess business holdings apply to "donor advised funds" (within the meaning of IRC section 4966(d)(2)) and to "supporting organizations" (within the meaning of IRC section 509(a)(3)). Until enactment of PPA 2006, the restrictions on excess business holdings applied only to private foundations.

(a) The excess business holdings rule applies to donor advised funds as if they were private foundations, but with extensive phased-in divestiture rules for existing holdings. IRC § 4943(e). In addition, for purposes of these new rules the term "disqualified person" is defined much more expansively than the IRC section 4946 definition applicable to private foundations, and it includes organizations controlled by the fund advisors or members of their family and organizations which receive substantially all their contributions from the fund advisors or related parties. IRC § 4943(e)(2).

(b) The excess business holdings rule applies to some, but not all, supporting organizations. The rules apply to (i) all "Type III" supporting organizations other than "functionally integrated Type III supporting organizations" (defined in IRC section 4943(f)(5) to mean a Type III supporting organization which is not required to make payments to supported organizations due to the activities of the organization related to performing the functions of, or carrying out the purposes of, such supported organization) and (ii) "Type I" supporting organizations if the supported organization is controlled by the supporting organization's donors. IRC § 4943(f)(3). As with donor advised funds, the term "disqualified person" is defined much more expansively than the IRC section 4946 definition applicable to private foundations, and it includes organizations controlled by the same persons who control the supporting organization and organizations which receive substantially all their contributions from the supporting organization's substantial contributors or related parties. IRC § 4943(f)(4).

F. Charitable Gifts to a Single-Member LLC Owned by Charity.

1. Background. Charitable organizations have attempted for many years to develop a way to accept gifts of real property or other problematic assets through some kind of limited liability entity, so that any environmental or other property-related liabilities would be contained in the entity and would not endanger the organization's other assets. A single-member LLC would be an ideal vehicle by which to accomplish this goal. Single-member LLCs are treated as "disregarded entities" for tax purposes, so no separate tax reporting is required, and generally the owner of the LLC is not responsible for any liabilities attributable to property owned by the LLC. The problem is that the Internal Revenue Service for many years refused to rule whether, even though a single-member LLC is a disregarded entity for tax purposes, gifts by a donor to a single-member LLC owned by a charitable organization would qualify for the income tax charitable deduction.

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

II. CHARITABLE GIFTS OF C CORPORATION STOCK

A. Generally.

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

B. Charitable Bailout.

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

C. Prearranged Redemptions and Assignment of Income Issues.

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

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

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

by the corporation to surrender the shares for redemption. The "bright line" test of *Palmer* and Revenue Ruling 78-197 has become somewhat muddled, and the bright line is not haze free.

4. <u>Fuzzing the Line</u>. In *Blake v. Commissioner*, 42 T.C.M. 1336 (1981), aff'd, 697 F.2d 473 (2d. Cir. 1982), the donor contributed stock to a charity with the understanding that the charity would permit the corporation to redeem the stock and the charity would then use the proceeds to buy the donor's yacht at an inflated price. The yacht was sold shortly thereafter by the charity for less than 50 percent of the price it had paid the donor. The Second Circuit Court of Appeals found the "understanding" enough to re-characterize the transaction as a sale of stock by the donor, followed by a contribution of the yacht to charity. Note that, unlike in other situations, there was a quid pro quo required by the donor in order for the donor to make the stock gift.

The next significant case was *Ferguson v. Commissioner*, 108 T.C. 244, (1997), aff'd, 174 F.3d 997 (9th Cir. 1999), which involved a gift of stock followed by a redemption pursuant to the terms of a merger agreement. The donors were directors and minority shareholders of Company A. On day 1, Company A entered into an agreement and plan of merger with Company B. Company A's board of directors (the donors abstaining) approved the merger and recommended it to the shareholders. On day 6, Company B made its tender offer. By day 34, more than 50 percent of the shareholders had tendered their shares. On day 43, the donors donated some of their Company A stock to a charity, which in turn immediately tendered the stock to Company B. On day 46, Company B announced its acceptance of all the tendered shares and purchased all of the shares on day 47. The Tax Court found that the donors were taxable on the gain from the stock transferred to charity because by the date of the gift the donors' interest had been converted from an interest in a viable corporation to a fixed right to receive cash. The Ninth Circuit Court of Appeals affirmed, holding that the transaction had "ripened" into a right to receive sale proceeds once 50 percent shareholder approval for the merger had been reached.

The application of Revenue Ruling 78-197 also arose in *Gerald A. Rauenhorst, et al. v. Commissioner*, 119 T.C. No. 9 (2002). In that case, Arbeit (a partnership) owned warrants enabling it to purchase NMG stock. On September 28, 1993, WCP (a corporation) offered to purchase all NMG stock. On November 9, 1993 the partnership assigned some warrants to four charities. On November 19 Arbeit sold its remaining warrant to WCP, and the charities sold their warrants to WCP. On November 22, 1993, WCP and NMG agreed on a sale of all the NMG stock. The government argued that the bright-line test of Revenue Ruling 78-197 was not controlling. The court held that, based on the facts of the case and the "no legal obligation" test of *Palmer* and Revenue Ruling 78-

197, there was no prearranged sale, and in the process took a very dim view of the government's urging to ignore the ruling:

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

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

> In the present case, at the time X shares are transferred to Trust, X will be under no legal obligation to redeem the contributed stock. There is no agreement among the parties under which X would be obligated to redeem, or Trust would be obligated to surrender for redemption, the stock. Trust is not legally obligated to accept any offer of redemption made by X. Accordingly, any redemption by X of the stock contributed by Grantors to Trust will be respected.
>
> Based on the representations submitted and information described above, we conclude that a purchase by X of the stock transferred by Grantors to Trust will be treated as a redemption of the stock from Trust, and will not be treated as a redemption of stock from Grantors or a distribution by X to Grantors. Therefore, the sale or redemption by Trust

> of its X stock will not result in the capital gain in such sale or the redemption price being attributed for tax purposes to Grantors.

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

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

See also Private Letter Ruling 200821024 to the same effect.

D. Redemption for a Promissory Note.

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

> Furthermore, the proposed transaction provides for an installment payment arrangement for the redemption of shares with part of the purchase price being paid in cash at the time of the redemption and the balance, pursuant to the

> terms of the transaction, being payable quarterly thereafter for the remaining ten year installment payment term. Thus, the retention by B of the redemption notes evidencing A's obligation to pay the balance of the redemption price is a part of the redemption transaction and is not self-dealing under section 4941(d)(2)(F) of the Code.

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

> In your letter dated June 24, 1992, you were concerned with the tax consequences of a redemption of shares of common stock from B following the donation of such shares to B by C. Redemption was to be accomplished through extensions of credit by A, a disqualified person with respect to B.
>
> On August 31, 1993, we issued a favorable ruling to B (PLR 9347035) on this request. Subsequent to the issuance of the ruling it was discovered that the ruling was contrary to Example 2 of section 53.4941(d)-3(d)(2) of the Foundation and Similar Excise Taxes Regulations. When B was informed of our intent to revoke the ruling, B indicated that the transaction was never entered into and asked that the ruling request be withdrawn. On October 27, 1994, we acknowledged the withdrawal of B's ruling request.
>
> This letter formally revokes PLR 9347035.

The answer thus appears to be a resounding "no."

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

3. <u>Distribution of Existing Notes</u>. There are rulings approving the distribution of an existing note under the probate exception. In Private Letter Ruling 200729043, for example, a decedent's revocable trust received notes of a disqualified person upon liquidation of a corporation. The trustee proposed allocating the notes to the share of a private foundation. The Service ruled that receipt of the notes by the private foundation would not be an act of self-dealing. See also PLR 199924069. None of these rulings involved a redemption or other "transaction" in the estate or trust that would be completed as part of the probate exception,

but instead merely a discretionary allocation of an existing note. For that reason, some planners take little comfort from the rulings, particularly in light of the recent rulings approving the use of an LLC to receive and hold notes of a disqualified person.

4. Use of LLC.

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

(b) In Private Letter Ruling 200635017, existing notes were contributed to an LLC and the notes were then purchased in a transaction approved under the probate exception. A brief summary of the principal facts resulting in a favorable ruling are as follows:

- A taxpayer (actually three similarly situated taxpayers) entered into a transaction resulting in her receipt of a promissory note of a family member (a disqualified person).
- The taxpayer created a single-member LLC, and transferred her note to the LLC in exchange for voting and nonvoting units.
- The taxpayer also entered into agreements with her children (disqualified persons), granting them an option exercisable at the death of the taxpayer to purchase the note (from the LLC) for fair market value.
- The taxpayer also created a private foundation (actually a charitable trust subject to the private foundation rules), and at the death of the taxpayer contributed the nonvoting units to the foundation.
- Shortly after the death of the taxpayer, her children purchased the note under the probate exception.

(c) In Private Letter Ruling 201407023, the Service approved under the probate exception the distribution to a foundation of nonvoting units in an LLC already holding the note of a disqualified person, ruling that neither the distribution of the LLC units nor the retention of the units by the foundation would be self-dealing, even though the sole asset of the LLC would be the note and payments on the note. Note that, in PLR 200635017, the foundation ultimately received (through the LLC) from disqualified persons the proceeds of sale of notes of other disqualified persons, whereas in PLR 201407023, the foundation continued to receive (through the LLC) payments on notes of disqualified persons. PLR 201407023 was issued to the donor. A companion ruling (PLR 201407021) was issued to the foundation.

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

III. CHARITABLE GIFTS OF PARTNERSHIP (OR LLC) INTERESTS

A. Donor Issues.

1. Phantom Income. Charitable gifts of interests in partnerships or limited liability companies can sometimes result in surprising and unfavorable tax consequences to the donor. The gift may result in the realization of ordinary income by the donor if the partnership has unrealized receivables or appreciated inventory, or if there is any investment tax credit subject to recapture. See generally IRC §§ 47 to 50 and 751(a). The gift could also accelerate any unrecognized installment gain in the partnership. See Rev. Rul. 60-352, 1960-2 C.B. 208.

2. Bargain Sale Rules. The so-called "bargain sale rules" apply to gifts of interests in partnerships with outstanding indebtedness, even if the indebtedness is nonrecourse and unsecured. The partner is treated as having received payment for his or her entire share of partnership liabilities. See IRC § 752; Treas. Reg. § 1.752-1(d). See also Rev. Rul. 75-194, 1975-1 C.B. 80. This can result in "phantom" capital gain income to the donor.

3. Valuation and Substantiation. A charitable gift of an interest in a partnership or LLC is generally treated as a gift of a capital asset, so a gift to a public charity generally would qualify for a full fair market value deduction. The Service quite properly asserts, however, that all the same valuation discounts promoted by donors of noncharitable gifts also apply to charitable gifts, so the appraised value of the interest transferred generally would be 10 to 50 percent less than the undiscounted value based on the value of the underlying assets. Gifts of such interests are subject to the "qualified appraisal" rules.

4. Prearranged Sale Rules. Although most of the reported cases and rulings deal with prearranged sales or redemptions of stock, the same principles would apply to gifts of partnership interests.

B. Donee Issues.

1. Unrelated Business Income.

(a) A tax-exempt organization, including a private foundation, pays tax on its unrelated business taxable income ("UBTI"). IRC § 511. UBTI is income from activities that: (1) are regularly carried on, (2) rise to the level of a trade or business, and (3) are substantially unrelated to the organization's exempt purposes. IRC §§ 512, 513. UBTI does not include passive income such as dividends, interest, most rents from real property, and gains from the sale of property (other than dealer property). IRC § 512(b). If a tax-exempt organization is a partner in a partnership that regularly carries on a trade or business that is unrelated to the exempt purpose of the organization, such organization shall, in computing its UBTI, include its share of partnership gross income from the unrelated trade or business and its share of partnership deductions directly connected with such gross income, subject to the exceptions for passive income. IRC § 512(c).

(b) Unlike the case with shares of S corporations held by tax-exempt organizations, a tax-exempt partner's share of partnership income and gain is not necessarily treated as unrelated business income. Instead, there is something of a "look through" rule. The charitable organization must include in its unrelated business income only its share of the partnership's income attributable to unrelated trade or business activities carried on by the partnership. IRC § 512(c). In other words, for purposes of this rule, the partner is treated as engaged in the same activities as the partnership. The tax-exempt partner's share of the partnership's dividends, interest, rents, royalties, and other "passive" income retains its tax-free character.

(c) The exclusion of rent from UBTI does not apply if the determination of rent depends in whole or in part on the income or profits derived by any person from the property leased (other than an amount based on a fixed percentage or percentages of receipts or sales). IRC § 512(b)(3)(B)(ii). In other words, rent is not passive income if it represents a portion of the tenant's net income or profit. Some commercial leases (including many shopping center leases) provide for both a fixed minimum rent and an additional percentage of gross receipts or sales from tenants, less agreed upon exclusions such as real estate taxes, property insurance, and common area maintenance paid by such tenants. To avoid UBTI for tax-exempt organizations owning rental property with such leases (or owning partnership interests in partnerships owning such rental property), care should be taken to craft a rental formula that avoids rent being treated as an interest in the profits of the tenant. For example, if percentage rent contains exclusions from gross receipts, such exclusions should be tied to expenses of the property and not to other activities of the tenant's business.

2. Debt-Financed Income.

(a) The exclusion from UBTI for income from passive activities is limited when the property giving rise to the income is financed by "acquisition indebtedness," that is, indebtedness incurred to purchase or improve the property (or indebtedness incurred before or after a purchase or improvement that would not have occurred but for such purchase or improvement). IRC §§ 514(a) and 514(c)(1). Where property is acquired (including by gift or bequest) subject to a mortgage or other similar lien, the amount of the indebtedness secured by such mortgage or lien is considered acquisition indebtedness even though the organization does not assume or agree to pay such indebtedness. IRC § 514(c)(2)(A).

(b) When there is acquisition indebtedness, a portion of the gross income (including capital gain) generated by the property is UBTI. Such portion is the ratio of the average acquisition indebtedness over the average adjusted basis in the property during the year. However, the acquisition indebtedness rule does not apply to the extent that the organization's use of the mortgaged property is substantially related to its exempt purposes. IRC § 514(b)(1)(A).

(c) Income or gain from debt-financed property is taxable in the same proportion that the acquisition indebtedness bears to the organization's income tax basis in the property. IRC § 514(a). The same basic rules apply to a tax-exempt partner's share of partnership debt-financed income or gain.

(d) Under the so-called "old and cold" exception, if mortgaged property (or an interest in a partnership that owns mortgaged property) is acquired by the organization as a result of a bequest or devise from a deceased donor, the indebtedness is not treated as acquisition indebtedness during the 10-year period following the date of acquisition. Where mortgaged property (or an interest in a partnership that owns mortgaged property) is acquired by the organization as a result of a gift from a living donor, the indebtedness is not treated as acquisition indebtedness during the 10-year period following the date of acquisition if: (i) the mortgage was placed on the property more than five years before the date of the gift and (ii) the donor owned the property for more than five years before the date of the gift. IRC § 514(c)(2)(B).

3. Payments of Income Tax. The charitable partner may be subject to income tax on its share of partnership unrelated business income, without regard to actual distributions from the partnership. It is important that the partnership agreement or LLC operating agreement require the entity to make distributions in an amount at least sufficient to pay any unrelated business income tax.

4. Capital Assessments. Although limited partners and members of LLCs generally are liable for partnership debts and expenses only to the extent of their investment, the terms of the partnership agreement or operating agreement can require partners or members to make additional capital contributions or other payments. The charitable donee should carefully consider these and other cash flow issues before accepting a gift.

5. Environmental Liabilities. The interest of a limited partner or a member of an LLC is personal property, even if the entity owns real property. The partner or member thus should not constitute an "owner" within the meaning of federal and state environmental laws, but in some cases the partner or member could be deemed an "operator" of property. A prudent charitable organization will undertake at least limited environmental due diligence before accepting an interest in any entity owning real property.

6. Donor Indemnities. With respect to any of these potential liabilities, a charitable donee may wish to consider requesting an indemnity from its donor.

IV. CHARITABLE GIFTS OF S CORPORATION STOCK

A. Before 1998.

Before 1998, a charitable organization could not be a qualified S shareholder. A gift of stock in an S corporation to a 501(c)(3) charitable organization automatically terminated the S election. Nor could a charitable remainder trust or pooled income fund hold stock in an S corporation. A charitable lead trust could be an S corporation shareholder only if it was a "grantor" trust. Similarly, stock in an S corporation could not be exchanged for a charitable gift annuity without destroying the S election. This problem became more acute after 1986, when the repeal of the *General Utilities* doctrine and changes in corporate and individual tax rates made the use of S corporations even more attractive.

B. After 1997.

1. Rules Broadened. The Small Business Job Protection Act of 1996 permitted charitable organizations to be S shareholders after December 31, 1997. IRC §§ 1361(b)(1(B) and (c)(6).

2. The Good News. The good news is that it became permissible to make gifts or sales of S corporation stock (a) to charitable organizations, (b) to charitable lead trusts that are grantor trusts or that make an Electing Small Business Trust ("ESBT") election under IRC section 1361(e), and (c) in exchange for a charitable gift annuity.

3. The Bad News.

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

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

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

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

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

V. USE OF A SUPPORTING ORGANIZATION TO HOLD S STOCK

A. Conventional Approach.

Because charitable organizations holding S corporation stock are subject to unrelated business income tax on the organization's share of corporate income and any gains realized on sale, the conventional analysis has been to consider the "best" way to minimize any income taxes. Frequently this analysis involves little more than the consideration of whether it would be better to organize the charity in trust or corporate form. Trusts are now subject to a higher maximum income tax rate than corporations, and trusts reach the top bracket much quicker (at taxable income of less than $13,000). However, charitable trusts are entitled to the same maximum rate on capital gain income as individual taxpayers, whereas corporations must pay income tax on capital gain at the usual rates. For these reasons, the conventional wisdom is that a charitable trust is preferable if it is expected that the stock will be sold relatively soon (because of lower capital gains tax rates). Otherwise, so the conventional wisdom goes, it is usually better to use a corporation (because of the lower maximum tax rate).

B. Use of a Supporting Organization.

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

> The contribution, whether made by a trust or other exempt organization, must be paid to another organization to be allowable. For example, a university described in section 501(c)(3) which is exempt from tax and which operates an unrelated business, shall be allowed a deduction, not in excess of 5 percent [now 10 percent] of its unrelated business taxable income, for gifts or contributions to another university described in section 501(c)(3) for educational work but shall not be allowed any deduction for amounts expended in administering its own educational program.
>
> Treas. Reg. § 1.512(b)-1(g)(3).

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

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

> In the case of any trust described in section 511(b), the deduction allowed by section 170 (relating to charitable etc. contributions and gifts) shall be allowed (whether or not directly connected with the carrying on of the trade or business), and for such purpose a distribution made by the trust to a beneficiary described in section 170 shall be considered as a gift or contribution. The deduction allowed by this paragraph shall be allowed with the limitations prescribed in section 170(b)(1)(A) and (B) determined with reference to the unrelated business taxable income

computed without the benefit of this paragraph (in lieu of with reference to adjusted gross income).

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

VI. CHARITABLE GIFTS BY THE BUSINESS ENTITY

A. Generally.

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

B. C Corporations.

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

C. S Corporations.

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

D. Partnerships and LLCs.

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

E. Impact of Section 337.

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