Charitable Gifts of Business Interests

November 2018
Estate and Gift Tax Charitable Deduction

IRC Section 2055 allows an unlimited estate tax charitable deduction for bequests to any charity.

IRC Section 2522 permits an unlimited gift tax charitable deduction for gifts made to charity.
# Summary of Income Tax Charitable Deduction Rules

<table>
<thead>
<tr>
<th>Type of Gift</th>
<th>Deductible Amount</th>
<th>Public Charity</th>
<th>Private Foundation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cash</strong></td>
<td>FMV</td>
<td>50% of AGI*</td>
<td>30% of AGI</td>
</tr>
<tr>
<td><strong>Ordinary Income Property</strong></td>
<td>Lesser of FMV or basis</td>
<td>50% of AGI</td>
<td>30% of AGI</td>
</tr>
<tr>
<td><strong>Appreciated LTCG Property</strong></td>
<td>FMV</td>
<td>30% of AGI</td>
<td>20% of AGI (May elect to apply 50% limit but deduction limited to basis)</td>
</tr>
<tr>
<td></td>
<td>Exceptions — limited to basis:</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Certain gifts to PF</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• TPP not related to exempt purpose</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Publicly traded stock</strong></td>
<td>FMV</td>
<td>30% of AGI</td>
<td>20% of AGI</td>
</tr>
<tr>
<td><strong>Carryover</strong></td>
<td></td>
<td>5 years</td>
<td>5 years</td>
</tr>
</tbody>
</table>

*60% of AGI from 2018-2025*
### Substantiation — Five Categories of Property

<table>
<thead>
<tr>
<th>Category</th>
<th>Instructions</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Less than $250 ($1–$249)</td>
</tr>
<tr>
<td>2</td>
<td>$250 or more but not more than $500 ($250–$500)</td>
</tr>
<tr>
<td>3</td>
<td>More than $500 but not more than $5,000 ($501–$5,000)</td>
</tr>
<tr>
<td>4</td>
<td>More than $5,000 but not more than $500,000 ($5,001–$500,000)</td>
</tr>
<tr>
<td>5</td>
<td>More than $500,000 ($500,000 and up)</td>
</tr>
</tbody>
</table>

* Artwork includes sculptures, watercolors, prints, drawings, ceramics, antiques, decorative arts, textiles, carpets, rare manuscripts, historical memorabilia and other similar objects.

Instructions to Form 8283.
Substantiation
COMMON ERRORS

- Statement of “goods or services” absent from contemporaneous written acknowledgement
- Incomplete appraisal summary (Form 8283)
- Untimely appraisal — done no earlier than 60 days before gift or received later than due date (plus extensions) of return
- Incorrect appraisal method
- Not signed by appraiser
- Unqualified appraiser
Three Options for Charitable Gifts of Closely Held Business Interests

<table>
<thead>
<tr>
<th>Give and Sell</th>
<th>Give and Hold</th>
<th>Gift by Business Entity of Underlying Asset</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Give to charity before entering into a binding agreement to sell.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Donor gets income tax charitable deduction</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Avoids or reduces tax on proceeds</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Gift of income producing business to charity without contemplation of a pending sale</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Business entity makes gift of asset</td>
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<td></td>
</tr>
</tbody>
</table>
Business
GIVE AND SELL

GIVE BUSINESS INTEREST TO CHARITY

- Donor avoids tax on portion of business interest given to charity
- Charitable recipient may be taxable on unrelated business taxable income (UBTI) upon subsequent disposition of the business interest
- Donors who are subject to the net investment income tax (NIIT) will avoid the 3.8% surtax on disposition of the business interest
- Tax consequences depends on the type of business interest being given to charity
Business
POTENTIAL COMMON ISSUES

Unrelated Business Taxable Income

Partial Interest Rule
UBTI DEFINED

• Defined, under IRC Section 512(a)(1), as net income received by an exempt organization from:
  – A trade or business
  – Regularly carried on
  – Substantially unrelated to the organization’s exempt purpose, or

• Debt-financed income
UBTI
STATUTORY EXEMPTIONS FROM UBTI

- Dividends, interest and annuities. Section 512(b)(1).
- Royalties. Section 512(b)(2).
- Rental income from real property. Section 512(b)(3)(A)(i).
- Capital gain on sale of appreciated capital assets. Section 512(5).
C Corporation Stock — Closely Held

UBTI

• C corporations generally do not subject charity to UBTI.

• Any distributions from C corporations to charitable shareholders are exempt from UBTI under the exception for dividends.

• Any gain realized on the sale of C corporation stock is capital gain, and is also excepted from the definition of UBTI.
Under IRC Section 511(e)(1), all flow-through income reportable to charity is treated as UBTI, even though characterization of the income item might have otherwise been excluded from UBTI, such as rent from real estate.

**Gain on sale is UBTI. Section 512(e).**
Income from UBTI-exempt sources, such as interest, dividends, capital gains, etc. retain the same character as if such income were realized directly from the source from which it was realized by the partnership. IRC Section 702(b).

Thus, the charity’s distributive share of these sources of income is exempt from UBTI as well.
Partial Interest Rule
GENERAL RULE

Gifts of Partial Interests — No deduction is allowed for income (§170(f)(2); §170(f)(3)(A); Reg. 1.170A-7(a)(1)), gift (§2522(c)(2); Reg. 25.2522(c)-3(c)(1)(i)) or estate (§2055(e)(2); Reg. 20.2055-2(e)(1)(i)) tax purposes unless the transfer is structured as a charitable remainder annuity trust, a charitable remainder unitrust or a pooled income fund.

A partial interest is defined as any interest in property that consists of less than the donor’s entire interest in the property
Partial Interest Rule

Exceptions

- All interests given to charity
- Gift of donor’s entire interest
- Undivided portion of entire interest
- Remainder interest in personal residence or farm
- Qualified conservation easement
- Future interest in tangible personal property
- Partial interest that would be deductible in trust
- Insubstantial retained interest
- Remoteness
C Corporation Stock — Closely Held
AFFECT ON DONOR

• Gift to public charity
  – Can deduct fair market value of long-term capital gain property

• Gift to private non-operating foundation
  – Can only deduct basis

• Charity wants an exit strategy
C Corporation Stock — Closely Held
AFFECT ON CHARITY

**Stock Sale**
- Capital gain to charity
  - Capital gain income is not unrelated business taxable income (UBTI)

**Asset Sale**
- Corporate-level tax
  - Distribution to charity would be a dividend or long-term capital gain (LTCG), avoiding additional tax
  - Distribution to charity not subject to 3.8% surtax
C Corporation Stock
CHARITABLE STOCK BAILOUT

Step 1
Donor contributes LTCG stock to charity. Result: Donor get FMV income tax charitable deduction

Step 2
Corporation redeems charity’s stock

Step 3
Charity gets cash for stock. Result: Earnings bailed out of corporation income tax free
C Corporation Stock — Closely Held
SALE PENDING

- **Situations**: Gift of stock to CRT, IPO, pending sale/merger, corporate inversion, charitable stock bailout

- **Test**: Is charity/donee legally bound or can be compelled to surrender shares for sale or redemption?
  - If so, the redemption/sale proceeds will be treated as income to the donor
  - Gerald A. Rauenhorst, 119 T.C. 157 /(2002) – court characterizes ‘legally bound” standard in Rev. Rul. 78-197 as the “bright line” test

- Facts and circumstances test

- Shareholder approval? Regulatory approval?
S Corporation Stock

Is charity an eligible S corporation shareholder?

Yes, if the organization is exempt from income tax under Section 501(a)

PROBLEMS

- Deduction equal to FMV of stock less recapture or ordinary income items for gift to public charity
- Gifts to private non-operating foundation limited to basis
- Charity subject to unrelated business income tax (UBTI) on S corporation income
- Charity subject to tax as UBTI on gain from stock sale. Section 512(e)(1)
- Illiquid
- Valuation needed
- Very popular prior to sale to private buyer — imputed gain

SOLUTION

S corporation gives assets to charity

- Charitable contribution limited to shareholder’s basis
- Contribution in excess of deduction limitation may be carried forward indefinitely
S Corporation Stock

- As mentioned, all income derived from S corporations, including capital gain in sale following a gift, is UBTI.

- How some charities lessen the impact of UBTI — establish supporting organization under Section 509(a)(3), organized as a trust
  - Allows charity to take advantage of a 50% charitable deduction available to trusts under Section 512(b)(11).
S Corporation Stock
CHARITABLE REMAINDER TRUST (CRT)

• Generally, a CRT cannot be a S corporation shareholder — it is not exempt under Section 501(a)

• However, a S corporation can establish a CRT with its shareholders as the non-charitable beneficiary. PLR 9340043.

• In PLR 9340043, the CRT was funded with a partnership interest, but only after the partnership had been stripped of any assets that created ordinary income.

• The IRS held that the contribution of the partnership interest was considered appreciated long-term capital gain, deductible as such, and the deduction flowed through to the sole shareholder
Partnership/LLC Interests

DONOR

Deduction equal to FMV of partnership interest less any ordinary income items less donor’s share of liabilities for gift to public charity

Ordinary income consists of gain component of (1) unrealized accounts receivable, (2) appreciated inventory and (3) depreciation recapture
Partnership/LLC Interests

DONOR

• Debt at partnership level is attributable to the partner

• Value of charitable gift must be reduced by amount of allocable debt to the donor/partner

• Interest subject to debt subject to bargain sale rules
Bargain Sale
DEBT ON PROPERTY

• If property is transferred subject to a debt, the donor is considered to have received consideration in an amount equal to the amount of the debt. Reg. 1.1011-2(a)(3).
  – Thus, gain must be recognized even though no cash has been received

• A contribution of encumbered property is treated as a bargain sale even if the debt is nonrecourse or the charity does not agree to assume the debt. Reg. 1.1011-2(a)(3).
EXAMPLE

Donor contributes LTCG property with a FMV of $25,000 and a basis of $15,000 to a public charity. The property is subject to a debt of $10,000. The donor receives no cash in the transaction.

Under the bargain sale rules, the donor is considered to have received consideration of $10,000, the amount of the outstanding debt.

The contribution deduction is $15,000, the $25,000 FMV of the property over the $10,000 consideration deemed received.

The basis is allocated proportionately to the sale portion (10/25 or 40%) and the gift portion (15/25 or 60%). Thus, the $15,000 basis is allocated. Thus, the sales portion is allocated a $6,000 basis (resulting in a $4,000 LTCG - $10,000 deemed sale less $6,000 allocated basis) and the contribution portion is allocated a $9,000 basis, which is wasted. Rev. Rul. 81-163, 1981-1 C.B. 433
Partnership/LLC Interests

**ISSUES**

- Is charity an acceptable partner?
- Is the partnership a suitable investment for the charity?
  - Capital call
  - Indemnification clauses
  - Transfer restrictions
  - Lack of control — minority gifts
  - Bargain sale rules apply if partnership interest is subject to liabilities
- Gift of partnership interest whose liabilities exceed cost basis trigger recognition of income (Crane business)
  - UBTI
  - Illiquid
  - Valuation
  - Unlimited liability if general partnership interest
- Charity should only accept limited partnership interests
- Loss of suspended PALs
Partnership/LLC Interests

PRIVATE FOUNDATION ISSUES

- Deduction equal to lesser of FMV or basis
- Self-dealing
- Jeopardy investments/diversification
- Excess business holding
Partnership
PRIVATE EQUITY/HEDGE FUND/CARRIED INTEREST

• Donate highly appreciated private equity fund interests to a public charity, including a donor-advised fund

• Donor receives a FMV (as determined by a qualified appraiser) income tax charitable deduction
  – Quarterly fund valuations may not be a qualified appraised value of the interest and the interest being transferred would be subject to a valuation discount

• Eliminates tax liability on fund distributions

• Public charities may be unwilling to accept gifts of private equity interests because they lack the resources to properly manage complex illiquid financial assets such as private equity or hedge fund interests
Partnership
PRIVATE EQUITY/HEDGE FUND/CARRIED INTEREST

• Donations must be approved by the private equity fund’s general manager and accepted by the charity or donor-advised fund.

• Some private equity funds have established charitable giving programs to enable their investors to make a charitable transfer of partnership interests or distribution of portfolio company stock prior to a sale.

• The charity or donor advised fund will generally not assume liabilities associated with private equity investments.
  – Donors should plan to contribute sufficient liquid assets to cover private equity funds open commitments, UBTI or other liabilities.
Partnership
PRIVATE EQUITY/HEDGE FUND/CARRIED INTEREST

• If the fund has debt, the donor may be liable for taxes if the contribution is treated as a bargain sale.

• UBTI issue on debt financed income

• To realize the full value of the investment, the charity or donor advised fund must normally hold the private equity investments until the scheduled termination date or liquidity event.
  – Sales of private equity interests in the secondary market prior to the termination date or liquidity event may be subject to substantial discounts
Partnership
PRIVATE EQUITY/HEDGE FUND/CARRIED INTEREST

• Avoid personal benefits for contributions to a donor advised fund

• No management fee — Interests contributed to a donor advised fund should not be charged a management fee, incentive fee or carried interest because the principal of the fund would be paid a portion of that fee. There should be a separate no-fee share class created for the contribution, or a waiver of fees agreement between the principal making the contribution and the donor-advised fund

• Not counted toward the principal’s minimum — the fund may require that the principal have a minimum amount of assets invested in the fund. Any interest owned by the principal’s donor-advised fund should not be counted toward that minimum as that could be deemed to be an indirect private benefit
• No ‘endorsements” — charities that operate donor-advised funds won’t accept the gift of a fund interest that constitutes more than 10% of the fund’s value. The reason is that potential investors may look think that a donor-advised fund’s acceptance of a greater percentage is an endorsement of the fund which could constitute an indirect benefit to the principal
Partnership
PRIVATE EQUITY/HEDGE FUND/CARRIED INTEREST

Donor advised funds may require a signed, written donation agreement covering the following issues before accepting an interest in a private equity fund or hedge fund:

- A representation that the contribution is less than 10% of the total value of the fund;
- Confirmation that no management fees, incentive fees or carry is being charged on the fund interest being contributed;
- An agreement to hold the donor advised fund harmless against future liabilities that may be incurred such as capital calls, claw backs or other liabilities;
- That tax on UBTI be covered either by income distributions from the private equity fund or hedge fund or from an additional contribution from the donor;
- The donor advised fund may sell its interest at any time based on the redemption terms or the fund.
Form 8283
NON-CASH CONTRIBUTIONS

COMPLIANCE ISSUES

• Required for non-cash contributions of greater than $500

• Items less than $5,000 and donations of publicly traded stock, form completed only by the donor and attached to his/her return

• Items greater than $5,000, signature by qualified appraiser is generally required as well as signature by donee organization. Form filed by donor with his/her return.

• Qualified appraisal attached to donee’s return for art valued at more than $20,000, conservation easements and other donations greater than $500,000.
Form 8282
SALES/DISPOSITIONS OF DONATED PROPERTY

Applies to donated items of $5,000 or more — excludes publicly traded stock

Applies if charity sells donated property within 3 years of donation

Must be filed with IRS within 125 days of sale/disposition
THANK YOU
Questions
Disclosure

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