5 WAYS TO USE CRTs AND DAFs WITH BUSINESS OWNERS

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CHARITABLE GIFTS OF BUSINESS INTERESTS USING CHARITABLE REMAINDER TRUSTS AND DONOR-ADVISED FUNDS

By
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Initial Observations about DAFs

Donor-Advised Funds (DAFs) are now codified in the Internal Revenue Code.[1] A DAF is:

- an account that is separately identified by reference to contributions of a donor or donors,
- which is owned and controlled by a sponsoring organization, and
- over which, the donor reasonably expects to have advisory privileges with respect to its grants or investments.[2]

The Sponsoring Organization for a DAF may not be a private foundation[3] or a Type III non functionally integrated supporting organization[4]. The Sponsoring Organization must be a publicly-supported charity. Despite the donor's retention of advisory powers with respect to the DAF, the Sponsoring Organization must exercise "exclusive legal control" over the DAF including all contributions to the DAF. This control extends to decisions regarding the DAF's management, liquidation, investments and grants. The Sponsoring Organization must explicitly inform every Donor to a DAF that the Sponsoring Organization must exercise "exclusive legal control" over all contributions to the DAF.[5]

If the Donor identifies the charity for any official purpose such as on an IRS form, the Donor should list the Sponsoring Organization (instead of the DAF) as the entity's name. Similarly, the Sponsoring Organization should be named in any will, trust or beneficiary designation form.

Sponsoring Organizations may make grants from a DAF to publicly-supported charities including to the Sponsoring Organization, to another Sponsoring Organization or to another DAF.[6] While a Sponsoring Organization may make a grant from a DAF to most types of supporting organizations, a DAF may not make a grant to a Type III non functionally integrated supporting organization[7] or any organization controlled by the

[1] See IRC §4966(d)(2).
[2] See IRC §4966(d)(2)(A).
[3] See IRC §4966(d)(1)(B).
[4] See IRC §170(f)(18)(A)(ii).
[5] See IRC §170(f)(18)(B).
[6] See IRC §4966(c)(2).
[7] See IRC §4966(c)(2)(A).

DAF's Donor.[8] Sponsoring Organizations may not use DAF assets for a noncharitable purpose[9] unless the grant is subject to an Expenditure Responsibility agreement.[10] Sponsoring Organizations and their DAFs may not reimburse the expenses of a Donor or a person appointed by a Donor.[11]

The Sponsoring Organization or its duly-authorized agent must exercise control over the DAF such as negotiating a sale of the DAF's assets or researching and making grants. Despite a Sponsoring Organization's formal control of a DAF, this paper embraces a conversational approach and often indicates that the DAF itself exercises some of these actions instead of the Sponsoring Organization.

Considerations When Selling a Small Business in a CRT or DAF

Business Form

Business entities come in many forms. Often, donors are unclear as to the actual business form under which their business is operating. In order to determine the actual form of the business entity, one should examine the organizing documents of the business and the tax form filed. See Table 1 for a listing of the required organizing documents and Federal tax forms filed for each business entity form.[12]

Table 1

Business Entity Forms	Organizing Documents	Tax Forms Filed
C-Corporation	Articles of Incorporation, By-laws	Federal Form 1120
S-Corporation	Articles of Incorporation, By-laws	Federal Form 1120-S
Partnership	Partnership Agreement	Federal Form 1065
Limited Liability Company (LLC)	Articles of Organization, By-laws	Federal Form 1065[13]

Understanding the business form is important to determine:

- What the donor can actually contribute to a charitable remainder trust (CRT) or donor-advised fund (DAF);
- The procedure that will be required to correctly transfer ownership;
- Whether the approval of others is required;
- The nature of the valuation required to substantiate a charitable deduction; and
- The applicability of various valuation discounts.

[8] See IRC §4966(d)(4).
[9] See IRC §4966(c).
[10] See IRC §4966(c)(1)(B)(ii).
[11] See IRC §§4966(c)(1), 4967 and 4958(f)(7).
[12] The treatment of Professional Corporations, Professional Partnerships, Professional Limited Liability Companies, Personal Holding Companies, Business Trusts and similar entities is beyond the scope of this paper.
[13] Under Treas. Reg. §301.7701, et. seq., a limited liability company is permitted to elect to be taxed as a partnership or corporation. If an LLC elects to be taxed as a corporation, it may further elect to be taxed as an S-corporation. If the LLC has elected to be taxed under either corporate form, then it will file the Federal form associated with the corporate form elected.

Property Ownership
Many donors fail to understand the nuances of property ownership. For example, financial and legal advisors often recommend that donors own real property inside a business structure or a trust. Often, the nature of these poorly-understood legal structures has little bearing on day-to-day management and ownership decisions—further masking the technical issues involved in contributing part of the business entity to a CRT or DAF. As a result, the gift planner often must dig deeper to ascertain whether a business or property is owned outright, through a family trust or one of the business forms described above.

> **Planning Pointer on Partnerships:**
> The check-the-box regulations found at Treas. Reg. §301.7701, allow LLCs to elect taxation as a partnership or corporation. Almost all LLCs elect to be taxed as a partnership for income tax purposes. Unless specifically noted, references to partnerships apply equally to general partnerships, limited partnerships (including family limited partnerships) and LLCs. Because an LLC could alternatively elect to be taxed as a C-corporation or S-corporation, care should be exercised to determine the tax status of any entity that is the subject of a CRT or DAF plan.

Ownership Transfer
A charitable contribution deduction is allowed in the year in which a charitable contribution is made.[14] A charitable contribution is complete when the donor relinquishes dominion and control over the contributed asset.[15]

In order to relinquish dominion and control over a contributed asset, the donor must observe the legal formalities of transferring title. The legal formalities to be observed will vary according to the asset being transferred and the rules of the applicable jurisdiction. However, properly following the prescribed procedures will establish the date of the contribution, ensure that the gift is respected, and reduce complications that could hinder subsequent sale of the contributed asset.

Limitations on the ability to transfer title to property in the business entity context may come from a number of sources. The entity's governing documents, state law and other relevant materials should be reviewed to ensure that proper procedures are followed. For example, corporate or LLC by-laws, shareholder agreements, articles of organization, partnership agreements, minutes of prior meetings of the governing body, loan covenants and state statutes governing liquidations are potential sources where one may find procedural rules and restrictions applicable to transfers.

> **Example**: RST Corporation's shareholder agreement requires the consent of all shareholders before transferring shares to any other party. Therefore, if a shareholder desires to fund a DAF with his RST stock, the approval of all other shareholders should be obtained and this approval should be documented by the corporate secretary in the

[14] See IRC §170(a)(1), Treas. Reg. §1.170A-1(b) and (e).
[15] See Treas. Reg. §25.2511-2(b).

permanent records of the corporation. In addition, the change in ownership should be documented in the RST Corporation's stock book, the old stock certificate canceled and a new stock certificate issued.

Example: The transfer of real estate to a CRT by a quit-claim deed may compromise the trustee's ability to issue a general warranty deed to a purchaser without incurring an unacceptable level of risk or going back to the donor to obtain a general warranty deed. Therefore, it is generally advisable to transfer real estate to a CRT with a general warranty deed.

Example: Where a CRT has received an interest in real estate, care should be exercised to ensure that the closing paperwork on the subsequent sale accurately identifies the CRT as the seller (or as one of the sellers in the case of a fractional ownership interest).

Restrictions on Transfer

In addition to following transfer-related procedural requirements, there may also be restrictions on transfer. The restrictions may limit the universe of permissible transferees, trigger a sale provision in a shareholder agreement upon transfer to a transferee outside a permissible list, limit the timing of transfers or otherwise cause unintended consequences.

Effective Date of Contribution

A contribution is generally effective on the date of delivery to the charitable recipient.[16]

Stock Gifts: The effective date of a contribution of stock in a closely-held corporation depends on how and to whom it is delivered. If a donor transfers a stock certificate to a Sponsoring Organization, CRT trustee or to their agent, the effective date of the contribution is the date the certificate is mailed or otherwise delivered.[17] On the other hand, if the donor instructs the issuing corporation to transfer shares to a CRT or DAF, the effective date of the contribution is the date the transfer is recorded on the books of the issuing corporation.[18]

Real Estate Gifts: The effective date of a contribution of real property will depend on the applicable state law. In general, the effective date is the date that the deed is signed <u>and</u> delivered to either the DAF's Sponsoring Organization or the CRT's trustee, but not later than the date on which the deed is recorded.[19]

Tangible Personal Property Gifts: The effective date of a contribution of tangible personal property (such as equipment used in a trade or business) is the date that the

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[16] See Treas. Reg. §1.170A-1(b).
[17] See Treas. Reg. §1.170A-1(b). *Londen v. Comm'r*, 45 T.C. 106 (1965); *Estate of Currey v. Comm'r*, T.C. 1981-40 (2-2-81).
[18] *Morrison v. Comm'r*, 53 TCM 251 (1987).
[19] *Dyer v. Comm'r*, 58 TCM 51, (1990); *Johnson v. Comm'r*., 57 TCM 394 (1989).

CRT trustee takes possession. It is also recommended that the donor prepare a transfer document describing the property transferred and that this document be counter-signed and dated by the CRT trustee to indicate acceptance of the gift. It is important to remember that if tangible personal property is contributed to a CRT, the donor's deduction will be limited to the donor's cost basis[20] as well as delayed until the CRT sells this property.[21] On the other hand, if the donor gives the tangible personal property to a DAF, while the deduction will (usually) still be limited to the donor's cost basis, the intervening interest rule will not apply.

Substantiating the Charitable Deduction

When claiming a charitable contribution deduction for a gift to a CRT, the donor must attach to the return a statement showing the computation of the present value of the remainder interest.[22]

In addition, for most gifts of unmarketable assets that result in claiming or reporting a deduction greater than $5,000, a qualified appraisal must be obtained.[23] For gifts of nonpublicly traded stock, the threshold is raised to $10,000.[24] Failure to obtain a qualified appraisal will generally result in the disallowance of the income tax charitable deduction and may result in the application of negligence and other penalties. If the deduction claimed is in excess of $500,000, then a copy of the qualified appraisal must be attached to the return on which the deduction is claimed.[25]

In determining whether a qualified appraisal is required for gifts by a pass-through entity such as an LLC, partnership, or S-corporation, the dollar thresholds noted above are applied at the entity level. Where an otherwise required qualified appraisal is not obtained or is deemed deficient, the deduction is denied at the member, partner or shareholder level.[26]

> **Example**: If an S-corporation makes a $20,000 charitable gift of an unmarketable asset, then the S-corporation must obtain the qualified appraisal. If the S-corporation fails to obtain the qualified appraisal, the S-corporation's shareholders may be denied the charitable deduction for failure to obtain the qualified appraisal even if the shareholder's portion of the charitable gift was only $2,000.

[20] The donor's deduction is limited to cost basis is because of the "deduction reduction" rule. See IRC § 170(e)(1)(B)(i) and PLR 9452026.
[21] The donor's deduction is delayed due to the "intervening interest" rule. See IRC §170(a)(3) and PLR 9452026.
[22] See Treas. Reg. §1.664-4(c).
[23] See IRC §170(f)(11)(C) and Treas. Reg. §1.170A-13(c)(2)(i).
[24] See Treas. Reg. §1.170A-13(c)(2)(ii).
[25] See IRC §170(f)(11)(D). This requirement was added by the American Jobs Creation Act for gifts after June 3, 2004.
[26] See IRC §170(f)(11)(G).

Qualified Appraisals
The Pension Protection Act of 2006 substantially increased the qualified appraisal rules and restricted the persons who are eligible to serve as qualified appraiser. The new rules are included as an Appendix to this paper.

Deductibility of Contributions for Gifts to a DAF

The Sponsoring Organization for a DAF may not be a private foundation[27] or non-functionally integrated supporting organization[28]. The Sponsoring Organization must be a publicly-supported charity. Therefore, gifts to a DAF will qualify for the best possible income tax charitable deduction.

Adjusted Gross Income[29] Limitations[30]

An individual taxpayer is permitted to claim a charitable contribution deduction to the extent of an allowable percentage of his adjusted gross income (AGI). Because a contribution to a DAF is a contribution to a public charity, the limit for cash contributions is 60% of the donor's AGI.[31] Likewise, if the donor contributes long-term capital gain property to a DAF, then the limit is 30% of the donor's AGI.[32]

A C-corporation donor is permitted to claim an income tax charitable deduction equal to 10%[33] of its taxable income[34] for gifts to a DAF.

Any unused charitable deduction may be carried forward for an additional five tax years[35] assuming the donor/entity remains alive or in existence. This carry forward rule applies to contributions by both individuals and corporations.

Deductibility of Contributions for Gifts to a CRT

The type of charity selected as the remainder beneficiary of a CRT will affect the income tax deductibility of a contribution. The IRS has ruled[36] that where one or more persons have the power to select a private foundation as the CRT's remainder beneficiary, then the contribution to the CRT is deemed to be made to a private foundation. This rule applies even where the charity initially named in the CRT document is a public charity.

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[27] See IRC §4966(d)(1)(B).
[28] See IRC §170(f)(18)(A)(ii).
[29] The technical term used in the statute is "contribution base." The contribution base is defined as adjusted gross income computed without regard to any net operating loss carryback to the taxable year. IRC §170(b)(1)(G).
[30] See Appendix B for a reference chart that describes the AGI Limitations for gifts of various kinds of property to both public charities and private non-operating foundations.
[31] See IRC §170(b)(1)(A).
[32] See IRC §170(b)(1)(C).
[33] See IRC §170(b)(2)(a).
[34] For C-corporations, taxable income is computed without regard to charitable contributions [§170(b)(2)(C)(i)], net-operating loss carryback [§170(b)(2)(C)(iii)], the domestic production activities deduction under IRC §199 [§170(b)(2)(C)(iv)] and IRC §1212(a)(1) capital loss carrybacks [§170(b)(2)(C)(v)].
[35] See IRC §170(d).
[36] See Rev. Rul. 79-368.

Adjusted Gross Income[37] Limitations[38]

An individual taxpayer is permitted to claim a charitable contribution deduction to the extent of an allowable percentage of his adjusted gross income (AGI). If the contribution is deemed to have been made to a public charity, then the limit for cash contributions is 50% of the donor's AGI.[39] Likewise, if the taxpayer contributes long-term capital gain property, then the limit is 30% of the donor's AGI.[40]

If the contribution is deemed to have been made to a private foundation, then the limit for cash contributions is 30% of the donor's AGI.[41] Likewise, if the taxpayer contributes long-term capital gain property, then the limit is 20% of the donor's AGI.[42]

A C-corporation is permitted to claim an income tax charitable deduction equal to 10%[43] of its taxable income[44] regardless of the public charity or private foundation status of the permissible charitable beneficiary(ies) of the CRT.

Any unused charitable deduction may be carried forward for an additional five tax years[45] assuming the donor/entity remains alive. This carry forward rule applies to contributions by both individuals and corporations.

Reduction to Tax Basis Rule

In addition to the AGI limits described above, a second rule applies to contributions of appreciated property to private foundations. For contributions of long-term capital gain property to a private foundation, the donor's deductible amount will be reduced to the donor's adjusted tax basis in the contributed asset. This reduction to tax basis rule also applies to charitable contributions made by C-corporations.[46]

The reduction to tax basis rule applies to any gift of long-term capital gain property other than "qualified appreciated stock".[47] Qualified appreciated stock is defined as stock in a corporation for which market quotations are readily available on an established securities market and the stock is capital gain property.[48]

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[37] The technical term used in the statute is "contribution base." The contribution base is defined as adjusted gross income computed without regard to any net operating loss carryback to the taxable year. IRC §170(b)(1)(G).
[38] See Appendix B for a reference chart that describes the AGI Limitations for gifts of various kinds of property to both public charities and private non-operating foundations.
[39] See IRC §170(b)(1)(A).
[40] See IRC §170(b)(1)(C).
[41] See IRC §170(b)(1)(B).
[42] See IRC §170(b)(1)(D).
[43] See IRC §170(b)(2)(a).
[44] For C-corporations, taxable income is computed without regard to charitable contributions [§170(b)(2)(C)(i)], net-operating loss carryback [§170(b)(2)(C)(iii)], the domestic production activities deduction under IRC §199 [§170(b)(2)(C)(iv)] and IRC §1212(a)(1) capital loss carrybacks [§170(b)(2)(C)(v)].
[45] See IRC §170(d).
[46] See IRC §170(e)(1).
[47] See IRC §170(e)(1). There are other rules that may come into play in rare circumstances.
[48] See IRC §170(e)(5).

Gifts to a CRT or DAF of an interest in a partnership, S-Corporation or an LLC taxed as a partnership are also subject to a rule that limits the donor's income tax deduction to the extent that any contributed asset would generate ordinary income on a hypothetical sale of that entity.[49] This is often referred to as a gift of a "hot asset".[50] For gifts of hot assets, the donor may have to recognize some ordinary income as a result of the charitable gift due to the bargain sale rules.

Tax Basis and Holding Period

In order to fully understand and quantify the tax benefits to be obtained from a contribution of a business interest to a CRT or DAF, it is important to determine the tax basis, holding period and other relevant tax characteristics. The ability to avoid the immediate taxation of unrealized gain upon the sale of a business transferred to a CRT or DAF is a primary tax benefit of making a charitable gift. The tax basis and holding period are two of the key factors required to compute the amount of unrealized appreciation inherent in a business interest and thereby measure the donor's tax benefit. To determine the tax basis and holding period, start by verifying how the donor acquired her interest in the business entity.

Among the ways a donor can acquire an interest in a business entity are:

- Create the business entity;
- Purchase an interest in the business entity;
- Receive an interest by gift;
- Receive an interest by bequest;
- Exercise non-qualified stock options (NQSOs); and
- Exercise incentive stock options (ISOs).

Interest Created by Donor. A business founded by the donor is likely to have little or no tax basis and therefore have significant unrealized appreciation. If, like most business founders, the donor waits several years before she is ready to give away a portion of her company to a CRT or DAF, her gift will qualify as long-term capital gain property.

Interest Purchased by Donor. A donor may have purchased a business interest. In this case, the purchase price establishes the starting point for determining the donor's tax basis. Appreciated business interests purchased more than one year prior to contribution to a CRT or DAF will qualify as long-term capital gain property.

Interest Acquired by Gift. Business interests may also be acquired by gift. In this case, the donor's tax basis and holding period in the business interest are the same as that of

[49] See IRC §170(e)(1)(A).
[50] See IRC §751.

the person from whom they received the business interest.[51] An adjustment is permitted for gift tax paid.[52]

Interest Acquired by Testamentary Transfer. Business interests acquired by testamentary transfer will generally have received a "step-up" in tax basis to the value included in the decedent's estate.[53] In addition, all such transfers are automatically treated as long-term capital gain property, regardless of the decedent's actual holding period. If the property was only recently acquired from the decedent's estate, then the amount of unrealized appreciation may be negligible.

Interest Acquired by Exercise of Non-Qualified Stock Options. Where a business interest was acquired by the exercise of non-qualified stock options,[54] the donor's tax basis will generally be equal to the fair market value of the stock on the date the options were exercised.[55] The holding period is determined by reference to the date the options were exercised, not the date the options were granted.[56] Therefore, the stock will be long-term capital gain property where the options were exercised more than one year prior to contribution to a CRT or DAF.

Interest Acquired by Exercise of Incentive Stock Options. Where a business interest was acquired by the exercise of ISOs,[57] the donor's tax basis for regular tax is equal to the option strike price—so long as the option was granted more than two years prior to the sale of the stock and the stock is sold more than one year after the exercise of the stock option.

However, because the excess of the fair market value of the underlying stock at the time of exercise over the strike price is a preference item for alternative minimum tax (AMT) purposes,[58] a donor's adjusted tax basis for AMT is equal to the fair market value at the time of exercise. The difference between the regular tax treatment of ISOs and the AMT treatment of ISOs may give rise to an AMT credit that will significantly reduce the tax paid upon sale of the stock.

Because the ability to use the AMT credit becomes limited when the stock that created the credit is used to make charitable contributions, the suitability of using such stock must be reviewed. For some donors, the loss of the ability to use the AMT credit may be outweighed by their desire to make the charitable gift.

[51] See IRC §1015(a)(1) and Treas. Reg. §1.1015-1(a)(1) for the rule regarding carryover of basis. See IRC §1223(2) for the rule regarding the tacking of the holding period.
[52] See IRC §1015(d) and Treas. Reg. §1.1015-5.
[53] See IRC §1014(a). Note that if the value of the property on the decedent's date of death was *lower than* the decedent's basis, there is actually a "step-down" in basis to the date of death value.
[54] Note that the rules regarding the transfers of non-qualified stock options *prior to exercise* are beyond the scope of this paper.
[55] See Treas. Reg. §1.61-2(d)(2)(i).
[56] See IRC §83(f).
[57] See IRC §422 for the definition of incentive stock options.
[58] See IRC §56(b)(3).

Qualified Intellectual Property

The valuation of most gifts of intellectual property is difficult and the recipient charity's ability to harvest that value is often uncertain. Therefore, the rules changed in 2004 for claiming charitable deductions for gifts of intellectual property. Intellectual property is defined as any of the following: patents, copyrights, trademarks, trade names, trade secrets, know-how, some software and similar property.[59] These assets are generally defined as "Qualified Intellectual Property".[60] Donors may deduct the smaller of their cost basis or the fair market value of the Qualified Intellectual Property they give to charity. With the exception of off the shelf software and a copyright created by or for the donor,[61] when the donor contributes the Qualified Intellectual Property to a publicly-supported charity, the donor may request (near the time of the gift) that the charity report to the donor how much net income the charity earns from the gift during the 10 years following the gift.[62] The donor can deduct this net income on a sliding scale based on information reported by the charity to the donor and IRS on Form 8899. The sliding scale is depicted in the following table:

DONOR'S TAX YEAR	APPLICABLE PERCENTAGE
1	100%
2	100%
3	90%
4	80%
5	70%
6	60%
7	50%
8	40%
9	30%
10	20%
11	10%
12	10%
13	0%

The IRS Form 8899 is due one month after the end of the charity's fiscal year. Net income received by the charity is defined as "Qualified Donee Income".[63] As with most charitable gifts, the donor may only claim a deduction for giving to charity her entire interest in the property. This deduction system closely correlates the donor's charitable deduction with the actual value received by the charity from the gift.

> **Example**: Patricia Patent creates a patent for a better mousetrap and incurs $50,000 of cost in the process. Patricia contributes the patent to ABC Charity on

[59] See IRC §170(e)(1)(B)(iii).
[60] See IRC §§170(m)(9).
[61] See IRC §§170(e)(1)(B)(iii) with 1221(a)(3).
[62] Additional deductions may be claimed for the shorter of 10 years following the gift or the remaining useful life of the Qualified Intellectual Property as of the gift date.
[63] See IRC §170(m)(3).

> August 31, 2012. Assuming the patent is appraised at more than $50,000, Patricia is eligible to claim a $50,000 income tax charitable deduction for her 2012 tax year. Although ABC Charity is a publicly-supported charity, Patricia does not notify ABC Charity that she intends to treat the patent gift as Qualified Intellectual Property; therefore, she may not claim any additional charitable deduction for her patent gift.

The donor cannot claim a double deduction for her basis in the Qualified Intellectual Property. Instead, the donor must reduce the net income reported on IRS Form 8899 by her cost basis.

> **Example**: Paula Tripp creates a patent for an even better mousetrap and incurs $35,000 of cost in the process. Paula contributes the patent to XYZ University on July 15, 2016. Assuming the patent is appraised at more than $35,000, Paula is eligible to claim a $35,000 income tax charitable deduction for her 2016 tax year. Additionally, because XYZ University is a publicly-supported charity and, in her gifting documents, Paula notifies the charity she intends to treat the patent gift as Qualified Intellectual Property, she may claim additional charitable deductions based on the net income received by XYZ University. However, Paula may not deduct the first $35,000 (her cost basis) of XYZ University's income from the Qualified Intellectual Property. XYZ University earns $20,000 of net income from the patent in 2016 and $95,000 in 2017 and reports those amounts on IRS Form 8899 to Paula and the IRS. During 2016, Paula can only deduct her $35,000 cost basis. For 2017, Paula may claim additional deductions after XYZ University's total earnings from the patent exceed her $35,000 cost basis. Therefore, for 2017, Paula may claim an additional deduction of $80,000, which represents XYZ University's total earnings of $115,000 minus Paula's cost basis of $35,000. If XYZ University earned an additional $100,000 in 2018, Paula could deduct an additional 90% of such amount, which is $90,000 on her 2018 tax return.

Qualified Donee Income can be claimed as a deduction as though the donor made the charitable contribution in the year for which the Qualified Donee Income is reported by the charity.[64]

> **Example**: Peter Caruso creates a patent for the best mousetrap and incurs $45,000 of cost in the process. Peter contributes the patent to State University on August 28, 2016. Assuming the patent is appraised at more than $45,000, Peter is eligible to claim a $45,000 income tax charitable deduction for his 2016 tax year. Additionally, because State University is a publicly-supported charity and Peter notifies the charity he intends to treat the patent gift as Qualified Intellectual Property, he may claim additional charitable deductions based on the net income received by State University. However, Peter may not deduct the first $45,000 (his cost basis) of State University's income from the Qualified Intellectual Property. State University earns $95,000 of net income from the patent in 2016 and $150,000 in 2017 and reports those amounts on IRS Form 8899 to Peter and the

[64] See IRC §170(m)(1).

IRS. For 2016, Peter can deduct $95,000, because his deductible amount for State University's Qualified Donee Income exceeds his basis. Peter's $95,000 charitable deduction in 2016 has the normal five-year carry forward to tax years 2017 through 2021. For 2017, Peter may claim an additional deduction of $150,000, which represents State University's Qualified Donee Income during 2017. Peter's deduction for State University's Qualified Donee Income of $150,000 as reported by the charity on Form 8899 for the tax year 2017 is treated as a charitable gift made during 2017 and may be carried forward for five additional years (2018 through 2022).

Importance of Fiscal Years. For donors whose fiscal year is a calendar year and who contribute Qualified Intellectual Property in January to a charity that also uses the calendar year as its fiscal year, the donor may deduct at 100% the first 23 months of Qualified Donee Income (e.g., for a Gift on January 15, 2016, Qualified Donee Income earned by the charity from January 15, 2016 through December 31, 2017). On the other hand, if the same donor makes the gift on December 15, 2016, then the donor can only "benefit" from the 100% deduction for a little over 12 months of Qualified Donee Income.

To further complicate matters, either the donor or the donee could have a fiscal year that is not the calendar year. It is not uncommon for a charity to have a fiscal year that is other than the calendar tax year. For example, many educational institutions use a fiscal year that ends in June. For such schools, the IRS Form 8899 must be filed with the donor and the IRS by July 31. If the donor files taxes on the calendar year, then the Qualified Donee Income reported on the Form 8899 filed by the charity for July 31, 2017 is reported by the donor on his/her 2017 tax return (which is first due during April 2018). It is important to note that for a gift on September 15, 2016 to a charity with a June fiscal year, the donor's first tax year ends December 31, 2016. The charity will not have filed a Form 8899 yet, so the donor gets no additional deduction for 2016 even if the charity generated Qualified Donee Income during the calendar year 2016. The first time the charity will file a Form 8899 is July 31, 2017, which occurs during the donor's second tax year. This is one reasons why the "Applicable Percentage" during the second tax year remains at 100%.

Donors who are not individuals, e.g., a business entity that uses a fiscal year, can further complicate matters. To push this example to the extreme, let's look at the example of a business that makes a contribution in November, the donating business has a November fiscal year and the charity has a January fiscal year. The donor's first year ends on November 30. Because the charity's fiscal year does not end until after the donor's first fiscal year end after the gift, the donor's first year will have zero Qualified Donee Income. Further, it is highly likely that the charity will not have been able to generate any significant Qualified Donee Income between the November gift and the end of the charity's fiscal year in January (just over 60 days later). Therefore, for year 2 of the donor's gift, the donor is unlikely to be able to claim an additional deduction. If the charity in this example, earned Qualified Donee Income in February (slightly more than 90 days after the original gift), the charity would not report that income on Form 8899 until February 28 of year 3. As a result, the donor's additional income tax deduction cannot be claimed until that third year.

Qualified Donee Income cannot be claimed as a deduction for gifts of Intellectual Property to a Charitable Remainder Trust.

> **Example**: Charles Robinson creates a patent for yet another mousetrap and incurs $25,000 of cost in the process. Charles contributes the patent to a CRT on November 15, 2016. Because Intellectual Property is automatically considered tangible personal property, Charles' deduction is limited to the smaller of his cost basis or the property value. Assuming the patent is appraised at more than $25,000, Charles is eligible to claim a $25,000 gift to his CRT. However, because Charles retained a life interest in the CRT, he can only claim an income tax charitable deduction for the actuarial present value of the remainder interest in his CRT, which is 10% of his gift. Although Charles' tax deduction is only $2,500, he has sheltered and deferred the gain realized when his CRT sells the patent.

Self-Dealing From Business-Used Real Estate (Applies to CRTs Only)

An issue that is peculiar to small business owners is the common practice of owning real estate used by the family business separately from the family business. This practice may result in self-dealing when the family business or a portion of it, is contributed to a CRT. The payment of rent by a CRT to a disqualified person is self-dealing.[65] A limited exception to the self-dealing rules may apply if the payment of rent is suspended.[66]

A second approach to addressing this common problem is to transfer the real property to the CRT at the same time as the family business. However, there is a hidden trap in this solution if the corporation continues to pay rent, because UBTI includes rents received by a CRT from a controlled entity.[67]

Excess Business Holdings[68]

If a specific DAF (in combination with that DAF's donors, advisors and their families) owns more than 20% of a business, then the Sponsoring Organization will owe an excise tax of 10% of the excess holding. If the Sponsoring Organization (and the parties described above) reduces its combined holdings below the 20% threshold within five (5) years of the gift, then the excess business holding tax does not apply.

On the other hand, the excess business holding rule rarely applies to CRTs because most CRTs may elect to avoid this rule with express language in the CRT document.[69] However, the rule must apply to every CRT in which a charity is named as an income beneficiary as well as to every CRT that continues as a private foundation after the end of the CRT's noncharitable period.

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65 See IRC §4941(d)(1)(A) and Treas. Reg. §53.4941(d)-2(b)(1).
66 See Treas. Reg. §53.4941(d)-2(b)(2).
67 See IRC §512(b)(13) and Treas. Reg. §1.512(b)-1(l).
68 See IRC §4943.
69 See IRC §4947(b)(3).

Assignment of Income

A basic principle of federal income tax law that income is taxed to the taxpayer who earned it.[70] The Assignment of Income doctrine prohibits the shifting of the income tax liability associated with recognition of gain away from a party whose right to the gain has matured.

Business owners contemplating funding a CRT or DAF most often encounter an Assignment of Income problem where the sale of the business has reached the point that the proposed buyer can force the owner to sell. Under the tax rules, the owner of the stock at the time an agreement to sell the stock becomes binding must pay any tax resulting from the sale even if the deal hasn't closed. When does an agreement become binding? As a general rule, an agreement is binding when the buyer can compel the seller to sell. The most obvious example of a binding agreement is a signed purchase agreement. Additional examples include a binding letter of intent and a purchase option that is binding on the seller. The following review of cases on Assignment of Income may shed light.

> **The *Kinsey* Case.**[71] A court ruled that where a plan of liquidation was adopted prior to the transfer of stock to a charity, the subsequent transfer of stock was ineffective in transferring the associated gain away from the donor to the charity.
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> **The *Salvatore* Case.**[72] Similarly, a court held that the transfer of stock in a corporation to a child violated the Assignment of Income doctrine, where the donor transferred stock to her children after a formal sales agreement had already been signed.
>
> **The *Jorgl* Case.** [73] A court held that where a CRT sold a corporation and the sales agreement included a covenant not to compete, the value of the noncompete agreement was properly assignable as income to the party bound by the covenant, notwithstanding the fact that the consideration for the covenant was paid to the CRT.
>
> **The *Greene* Case.**[74] Alternatively, a court held that where the receiving charity was expressly and solely in control of the decision of when to sell, the donor's right to the gain had not sufficiently matured and the donor was therefore not liable for tax on the gain. The court found this to be true, even though the donor was a member of the donee charity's board of directors.
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> **The *Palmer* Case.**[75] A court ruled that a contribution on Wednesday of stock in a corporation to a private foundation, followed by the corporation's independent offer

[70] *Lucas v. Earl*, 281 U.S. 111, 8 AFTR 2d 10287, 1930.
[71] See *Kinsey v. Comm.*, 477 F.2d 1058, 31 AFTR 2d 73-1262 (2d Cir. 1973)
[72] See *Salvatore v. Comm.*, 434 F.2d 600, 26 AFTR2d 70-5857 (2d Cir. 1970).
[73] See *Jorgl v. Comm.*, 264 F.3d 1145, 88 AFTR 2d 2001-5182 (11th Cir. 2001).
[74] See *Greene v. U.S.*, 13 F.3d 577, 73 AFTR 2d 94-746 (2d Cir. 1994).
[75] See *Palmer v. Comm.*, 62 T.C. 684 (1974), aff'd on another issue, 523 F.2d 1308 (8th Cir. 1975).

to redeem the stock on Thursday at 10:00 AM, followed by the foundation's acceptance of the redemption offer on Thursday at 2:00 PM, did not violate the Assignment of Income doctrine. This was found to be true, even though the donor had voting control of both the corporation and the recipient private foundation. One key to the court's favorable ruling was that each decision made by the respective parties was arrived at independently of the other decisions (i.e., the decisions were not part of an integrated plan that would create grounds for a finding that a step transaction had occurred). The IRS issued Rev. Rul. 78-197[76] acquiescing to the outcome of the Palmer case stating:

> The Service will treat the proceeds of a redemption of stock under facts similar to those in *Palmer* 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.

Where negotiations have already commenced prior to a charitable gift, prudence dictates that negotiations be halted before the proposed buyer can force a sale, complete the gift, and then, resume negotiations by the new owners. Where the CRT or DAF is the controlling party after the transfer, the CRT trustee or the Sponsoring Organization should control the negotiations (either directly or through a duly authorized agent). Where the CRT trustee or DAF is not the controlling party (e.g., in the case of a minority interest transfer), the CRT trustee or the Sponsoring Organization should document its steps to exercise all appropriate rights and duties of ownership. In addition, it is generally prudent for an independent trustee[77] (or independent special trustee) to represent the CRT in all negotiations and the sale closing.

As a final note, a finding that there has been an Assignment of Income does not disqualify the charitable gift. For example, the CRT continues to be a validly created trust under state law, is still a tax-exempt entity under IRC §664, the contributed assets are still effectively removed (in most cases) from the donor's taxable estate and the donor still may claim an income tax charitable deduction.[78]

Asset Sale vs. Stock Sale

It is common for the sale of a closely-held business to be structured as the purchase of the entity's assets rather than the sale of the legal entity. From the buyer's perspective this makes sense for one or more of the following reasons:

- The buyer wants to avoid becoming responsible for the liabilities (identified or unidentified) of the seller;
- The buyer only wants to acquire a portion of the assets of the business entity; or
- The buyer wants to reset the tax basis for depreciation of the purchased assets.

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[76] See 1978-1 CB 83.
[77] For the definition of an independent trustee, see IRC §674(c) and Treas. Reg. §1.664-1(a)(7).
[78] Arguably in this case, the deduction should properly be treated as a cash contribution. This will result in an enhanced deduction (higher AGI limitation) that can be used to partially offset the newly assigned income.

After the repeal of the *General Utilities*[79] doctrine by the Tax Reform Act of 1986, the corporate-level tax cannot be avoided by distributing the assets of the corporation in-kind to its shareholders. Similarly, when a corporation sells its assets and then distributes the cash proceeds to its shareholders, tax is paid by the corporation on the sale of the assets and also by the shareholder upon the liquidation of the corporation.

A consequence of this double-taxation regime on corporate liquidations is that a CRT or DAF that holds C-corporation stock cannot shelter from taxation the corporate-level tax resulting from an asset sale. However, where it is possible to sell the stock of a corporation to a prospective buyer, a CRT or DAF can avoid the immediate taxation of the gain realized upon the sale of the corporation.

Where assets of the corporation are distributed in-kind as a liquidation of a corporation, taxable gain is deemed to be realized by the corporation immediately prior to distribution to the extent that the fair market value of the assets distributed exceeds the corporation's adjusted tax basis in the assets.[80]

Each shareholder is then subjected to a shareholder-level tax on the liquidating distribution. If the distribution is a distribution in complete liquidation of the corporation, then the shareholder is considered to have sold a capital asset. The gain realized is the excess of the fair market value of the assets received over the shareholder's adjusted tax basis in the corporate stock.[81]

> **Example**: Paul Hussey, the 100% shareholder of Hussey Publishing, Inc. (HPI), a C-corporation, transfers 75% of his shares to a CRT. Then Paul and the CRT trustee sell their stock in the company to BigPub, Inc. HPI will owe no corporate-level tax on this transaction. Both Paul and the CRT receive the undiminished proceeds from the sale of the stock. While Paul will recognize a taxable gain to the extent of his retained 25% interest, the CRT will pay no tax on the gain realized on its 75% interest. Note, however, that this gain is recorded in the class of "all other long-term capital gains and losses" in Tier 2 of the 4-tiers.

> **Example:** The facts remain the same as the previous example, except that BigPub, Inc. purchases the assets of HPI. In this case, HPI must first pay a corporate-level tax on the gain realized from the sale of its assets to BigPub, Inc. Upon the subsequent complete liquidation of HPI, the net proceeds (after paying the corporate-level tax) are then distributed to Paul and the CRT. Paul will then pay a second, shareholder-level tax on his 25% retained interest in HPI and the CRT will pay no tax on the gain realized from its 75% interest. As noted in the previous example, this gain is recorded in the class of "all other long-term capital gains and losses" in Tier 2 of the 4-tiers.

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[79] In *General Utilities & Operating Co. v. Helvering*, 16 AFTR 1126 (56 S.Ct. 185), 12/09/1935, the Court allowed a corporation to avoid recognition of gain upon the distribution of appreciated property to its shareholders.
[80] See IRC §§311(b) and 336(a).
[81] See IRC §331(a).

Partial Asset Sale. Where a partial asset sale is followed by a distribution of the proceeds, the distribution is generally first taxed as a dividend to the extent of the corporation's undistributed earnings and profits, second as a return of the shareholder's tax basis in the corporation and third as gain to the extent of the remainder of the distribution.[82] Where the distribution is a redemption of stock, other rules may apply that may treat the distribution as a sale of the redeemed stock.[83]

Transfers of Encumbered Property to a DAF

The transfer of encumbered property to a DAF could potentially create several problems for the donor and/or the Sponsoring Organization.

Unrelated Business Taxable Income. When a DAF receives property subject to a loan, income generated by that property (including gain on the sale of the property) creates unrelated debt-financed income (UDFI),[84] a form of unrelated business taxable income (UBTI).[85] This rule not only applies to mortgaged real property, but also to corporate stock pledged as security for a loan.

When a DAF recognizes UBTI, such income is subject to regular income tax imposed on the Sponsoring Organization. The applicable tax rate will vary depending on whether the Sponsoring Organization is structured as a corporate or trust. Therefore, where assets of an operating business are the subject of a proposed transfer to a DAF, consideration must be given to whether such assets will create UBTI.

> **Example**: Mary Tucker, Inc., an S-corporation, transfers a multi-family apartment building to a DAF. Most real property rents received by a DAF meet an exception to the definition of UBTI.[86] Therefore, the rents received by the DAF likely will not create UBTI for the DAF.

> **Example**: M. T. Boyer, Inc., an S-corporation, owns as its sole asset a furnished vacation condominium. The corporation transfers 35% of its interest in the condominium to a DAF. Four percent (4%) of the weekly rental receipts are allocable to the rental of the furnishings. Because no more than 10% of the rents received are allocable to personal property, none of the rents received by the DAF are UBTI.[87]

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[82] See IRC §301.
[83] See the rules under IRC §§302 and 303.
[84] See IRC §514(b).
[85] IRC §514(c)(2)(B) provides that for ten years after contribution, the general rule that a mortgage creates acquisition indebtedness does not apply where the DAF acquires property by gift *subject to* a mortgage placed on the property more than five years before the gift and the donor held the property for more than five years.
[86] See IRC §512(b)(3). Note that if any portion of the rents received is based upon the income or profit derived by any person from the leased property, then such portion is UBTI.
[87] See Treas. Reg. §1.512(b)-1(c)(2)(ii)(b). If the rents allocable to personal property exceed 50% of the total rent, then *all of the rent* is UBTI. If the rents allocable to personal property are greater than 10% but 50% or less of the total rent, then that portion of the total rents is UBTI.

Example: J.R. Krebbs, Inc., an LLC, owns as its sole asset a furnished vacation condominium. The LLC transfers 40% of its interest in the condominium to a DAF. Fourteen percent (14%) of the weekly rental receipts are allocable to the rental of the furnishings. Because the rents received that are allocable to personal property are greater than 10% and 50% or less than the total rent, the portion of the rents received by the DAF that are allocable to personal property (14%) are UBTI.[88]

Example: Carroll Excavating, LLC (CEL) routinely sells fully depreciated, obsolete equipment that it no longer uses in its trade or business—often at a gain. This time, CEL elects to transfer some of its obsolete equipment to a DAF. Gain generated by a DAF from the occasional sale of property meets one of the exceptions to the definition of UBTI.[89] Therefore, so long as the DAF's sales are not deemed regular, gains received by the DAF on occasional sales of property are not UBTI.

Example: Ralph Lovell owns Lovell Homes Inc., an S-corporation, and was recently approached by a competitor who proposed to purchase Lovell Homes. Ralph has supported Hometown Charity for years and wants to make sure Hometown Charity gets some of the proceeds. Before Ralph is obligated to sell, he gives 15% of the S-corporation share to Hometown Charity. While a charity is a permissible holder of S-corporation stock,[90] Hometown Charity will recognize UBTI[91] on any deemed distributions from the S-corporation as well as on any sale of the shares.

Bargain Sale Treatment. The transfer of encumbered property to a DAF will result in the deemed sale by the donor of a fractional portion of the encumbered property and the donor's recognition of capital gain. The amount deemed realized is equal to the debt.[92] To compute the taxable gain, a portion of the donor's tax basis in the property is allocated to the amount deemed realized. The tax basis allocated is computed by first dividing the amount of the debt by the fair market value of the property and then multiplying this fraction by the donor's adjusted tax basis in the property.[93] The donor's remaining, unallocated basis becomes the DAF's tax basis in the property.

Partnership Planning Pointer: A similar result will be reached where a donor contributes a partnership interest and the partnership is liable for indebtedness. In this case, the value of the donor's share of the partnership's liabilities is treated as an amount realized from the sale of property (i.e., sale proceeds). To arrive at the taxable amount, the "sale proceeds" are reduced by an allocable share of the donor's adjusted basis in the partnership interest. See Revenue Ruling 75-194.

[88] See Treas. Reg. §1.512(b)-1(c)(2)(ii)(b). If the rents allocable to personal property exceed 50% of the total rent, then *all of the rent* is UBTI. If the rents allocable to personal property are greater than 10% but 50% or less of the total rent, then that portion of the total rents is UBTI.
[89] See IRC §512(b)(5) and PLR 9413020.
[90] See IRC §1366(c)(6).
[91] See IRC §512(e)(1).
[92] See Treas. Reg. §1.1011-2(a)(3).
[93] See IRC §1011(b).

When computing the charitable deduction for property subject to a mortgage or other encumbrance, the value of the property is first reduced by the value of the encumbrance.

Transfers of Encumbered Property to a CRT

The transfer of encumbered property to a CRT could potentially create several problems.

Unrelated Business Taxable Income. When a CRT receives property subject to a loan, income generated by that property (including gain on the sale of the property) creates unrelated debt-financed income (UDFI),[94] a form of unrelated business taxable income (UBTI).[95] This rule not only applies to mortgaged real property, but also to corporate stock pledged as security for a loan.

When a CRT recognizes UBTI, such income is subject to a 100% excise tax.[96] Therefore, where assets of an operating business are the subject of a proposed transfer to a CRT, consideration must be given to whether such assets will create UBTI.

> **Example**: J. Danforth, Inc., an S-corporation, transfers a multi-family apartment building to a CRT. Most real property rents received by a CRT meet an exception to the definition of UBTI.[97] Therefore, rents received by the CRT generally do not create UBTI for a CRT.
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> **Example**: J. L. Lissberger, Inc., an S-corporation, owns as its sole asset a furnished vacation condominium. The corporation transfers 35% of its interest in the condominium to a CRT. Four percent (4%) of the weekly rental receipts are allocable to the rental of the furnishings. So long as no more than 10% of the rents received are allocable to personal property, then none of the rents received by the CRT are UBTI.[98]
>
> **Example**: Rabb Products, Inc. (RPI) routinely liquidates fully depreciated, obsolete equipment that is no longer used in its trade or business—often at a gain. RPI elects to transfer this obsolete equipment to a CRT. Gain generated from the sale of property meets one of the exceptions to the definition of UBTI.[99] Therefore, gains received by the CRT are not UBTI.

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[94] See IRC §514(b).
[95] IRC §514(c)(2)(B) provides that for ten years after contribution, the general rule that a mortgage creates acquisition indebtedness does not apply where the CRT acquires property by gift *subject to* a mortgage placed on the property more than five years before the gift and the donor held the property for more than five years.
[96] See IRC §664(c)(2). This is the rule for CRTs that receive UBTI for tax years beginning January 1, 2007. Under prior law, a CRT lost its tax-exempt status for each year in which it received UBTI.
[97] See IRC §512(b)(3). Note that if any portion of the rents received is based upon the income or profit derived by any person from the leased property, then such portion is UBTI.
[98] See Treas. Reg. §1.512(b)-1(c)(2)(ii)(b). If the rents allocable to personal property exceed 50% of the total rent, then *all of the rent* is UBTI. If the rents allocable to personal property are between 10% and 50% of the total rent, then that portion of the total rents is UBTI.
[99] See IRC §512(b)(5) and PLR 9413020.

Example: Carter Excavating, Inc. (CEI) has been approached by a competitor who proposes to purchase all of CEI's assets (including equipment, land and goodwill). Bob Carter would like to avoid a portion of the gain on the sale of CEI's assets by transferring 60% of the assets of CEI to a CRT. However, because CEI is a vibrant business, Bob would like to continue to operate CEI during the period from the time of contribution to the subsequent sale of the assets. Because CEI's income from operations is gross income from an unrelated trade or business,[100] the CRT's 60% of the income generated during this period is UBTI.[101] Because of the 100% excise tax, the CRT will pay all of that UBTI as a federal excise tax.

Self-Dealing. In addition to UBTI concerns, if a CRT trustee accepts responsibility for a donor's obligation to pay a debt associated with encumbered property, then the trustee and the donor have engaged in a prohibited act of self-dealing.[102] Acts of self-dealing require the payment of excise taxes by both the trustee and the donor as well as reporting and corrective actions.

Bargain Sale Treatment. The transfer of encumbered property to a CRT will result in the deemed sale by the donor of a fractional portion of the encumbered property and the donor's recognition of capital gain. The amount deemed realized is equal to the debt.[103] To compute the taxable gain, a portion of the donor's tax basis in the property is allocated to the amount deemed realized. The tax basis allocated is computed by first dividing the amount of the debt by the fair market value of the property and then multiplying this fraction by the donor's adjusted tax basis in the property.[104] The donor's remaining, unallocated basis becomes the CRT's tax basis in the property.
When computing the charitable deduction for property subject to a mortgage or other encumbrance, the value of the property is first reduced by the value of the encumbrance.

Where a CRT's income is used (or may be used in the discretion of a nonadverse trustee) to satisfy an obligation of a donor, then the CRT will be treated as a grantor trust and fail to qualify as a CRT.[105]

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[100] IRC §513(a) states in part "The term 'unrelated trade or business' means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption ***under section 501*** (or, in the case of an organization described in section 511(a)(2)(B) , to the exercise or performance of any purpose or function described in section 501(c)(3))" [emphasis added]. A CRT derives its exemption from income tax from IRC §664, not §501. Therefore, it is not possible for a CRT to qualify for an exemption from unrelated business classification by virtue of claiming that a trade or business is substantially related to the purpose for which it was granted an exemption.
[101] See IRC §512(a)(1).
[102] See IRC §4941(d)(2)(a) and Treas. Reg. §53.4941(d)-2(a)(2). Treas. Reg. §53.4941(d)-2(a)(2) provides a limited exception to the general prohibition against self-dealing where a CRT trustee accepts encumbered property *subject to* an outstanding indebtedness that was placed on the property by a disqualified person 10 or more years prior to the transfer of the property to the trust.
[103] See Treas. Reg. §1.1011-2(a)(3).
[104] See IRC §1011(b).
[105] See IRC §677(a)(1), Treas. Reg. §1.677(a)-1(d) and PLR 9015049.

Bargain sale treatment also exists when a donor contributes a partnership interest and the partnership is liable for indebtedness. In this case, the value of the donor's share of the partnership's liabilities is treated as an amount realized from the sale of property (i.e., sale proceeds). To arrive at the taxable amount, the "sale proceeds" are reduced by an allocable share of the donor's adjusted basis in the partnership interest.[106]

Selected Other Risks

Risk of Delayed Sale
Illiquidity. The market for closely-held business interests is limited and, therefore, a closely-held business interest is inherently an illiquid asset. As a result of this illiquidity, the CRT's trustee or DAF may experience difficulty in funding required distributions and paying carrying costs.

When contemplating a transfer to a CRT, the impact of this limited marketability and illiquidity should affect the CRT format selected and/or the decision to contribute additional, liquid assets. To eliminate the problem created by required distributions and illiquidity, it is common to select the net-income with make-up charitable remainder unitrust (NIMCRUT) or flip charitable remainder unitrust (Flip-CRUT) format. In either of these formats, the trustee should only be required to distribute net income, thereby more closely matching the CRT's required distributions with the CRT's available liquidity.

Gifts of an illiquid, non-income producing asset to a DAF should impact the DAF's spending and investment policies as well as the proposed charitable uses in the near future. For example, if the asset is not sold, then the DAF won't be able to pay for the professorship, acquire museum assets or support the missionaries. Further, if a DAF owns certain business interests longer than five (5) years, an Excess Business Holding tax will apply.[107]

Potential Requirement to Make an In-Kind Distribution (CRTs Only). Where a distribution is required by a CRT (e.g., because the CRAT or SCRUT format was selected) and there is insufficient liquidity to fund the distribution, the CRT trustee may be required to make an in-kind fractional interest distribution of some of the trust's assets to the CRT beneficiary. This type of distribution creates at least two problems:

- Valuation of the property to be transferred; and
- Taxation of the distribution to the beneficiary.

In the case of valuing the property, the trustee will likely incur the cost of an appraisal as well as the cost associated with re-titling a fractional interest in the beneficiary's name.

When a CRT distributes property in-kind to make a required distribution, the CRT trustee is deemed to have sold to the beneficiary the distributed property immediately prior to the

[106] See Revenue Ruling 75-194.
[107] See IRC §4943.

distribution.[108] To the extent that the fair market value of the property distributed exceeds the CRT's adjusted tax basis in the property, the CRT trustee must record the gain in the capital gain tier. This gain is then included in determining the tax character of the distribution in the hands of the income beneficiary as reported on form Schedule K-1. The income beneficiary is then confronted with reporting taxable income, but not having received cash from the CRT with which to pay the tax.

Requirement to Periodically Value the CRT's Assets and Liabilities. The CRT's ownership of unmarketable assets provides an ongoing challenge to CRT administration because of the annual requirement to value the trust's net assets and the need to substantiate the authority for the value used. A CRT trustee will need the value of the trust's net assets in order to:

- Determine the value of the trust's assets and liabilities in order to compute the unitrust amount;
- Value any additional contribution for the incremental change in the unitrust amount for the year of contribution; and
- Compute the fraction of the entity to transfer to make an in-kind distribution in satisfaction of a required distribution.

A CRT trustee may substantiate the value of the trust's net assets by obtaining a qualified appraisal or using a value determined by an independent trustee.[109] The value of a contributed business interest should consider the applicability of discounts, including discounts for lack of marketability and minority interests. The value of a real property interest should consider the applicability of discounts for the presence of environmental contamination, fractional ownership interests and other impediments to sale.

[108] See Treas. Reg. §1.664-1(d)(5).
[109] See Treas. Reg. §1.664-1(a)(7).

Technique #1 -- Sale of a Corporation by a CRT

The most straightforward technique for using a CRT with a business owner is for the business owner to contribute corporate stock to a CRT. A common motivation for creating a CRT is the expected sale of the family business coupled with charitable goals.

> **Example:** John and Judy Freeman, both age 65, have owned and operated Freeman Enterprises, Inc (FEI) for the past 35 years. A number of competitors have made inquiries regarding the Freemans' desire to sell. John and Judy are ready to retire and want to give something back to their community.
>
> FEI is currently valued at $10 million. John and Judy's tax basis is less than $100,000. Their overall net worth is $12 million not including their personal residence.
>
> After considering their other estate planning goals and liquidity needs, John and Judy decide in conjunction with their advisors that a transfer of 30% of the outstanding FEI stock to their CRT is appropriate. The gift planning team recommends that the CRT utilize a flip provision to minimize the risk associated with a delayed sale. The advisors are careful to ensure that the CRT's remainder interest must be paid to a public charity. John and Judy also obtain a qualified appraisal for their transfer of 30% of the FEI stock to their CRT in order to substantiate their charitable income tax deduction.
>
> After the contribution, the CRT trustee successfully negotiates the sale of the FEI stock to a major competitor.
>
> As a result, the gain on the sale of FEI that is attributable to the CRT is sheltered from immediate taxation. John and Judy receive a current income tax deduction, a unitrust interest for life and the value transferred to the CRT is removed from their taxable estate. At the death of the survivor, a significant gift will be made to charities in their community.

Additional Considerations Unique to S-Corporations

Termination of S-Election

As an impermissible shareholder of an S-corporation,[110] the transfer of even one share of stock in an S-corporation to a CRT will trigger the immediate termination of the corporation's S-election.[111] The effect of this termination is to create two taxable years within the calendar year in which the S-election terminates—one for the period of the calendar year for which the corporation was an S-corporation and one for the period of the year for which the corporation was a C-corporation.

Planning Pointer

If stock in an S-corporation will be given to a CRT, the author strongly recommends that the company *affirmatively revoke its S-election before* the transfer to the CRT. By making an affirmative revocation, it should be clear to all parties that the S-election is being terminated.

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[110] See IRC §1361 for the description of permissible shareholders.
[111] See IRC §1362(d)(2)(B).

While the loss of an S-election should not be taken lightly, it is not necessarily catastrophic. If the plan is to sell the stock contributed to the CRT or exchange the stock for stock in a publicly traded company, then the loss of the S-election is generally a nonevent.

However, a number of negative factors should be considered:

- Double taxation of corporate earnings;
- Assuming only a portion of the outstanding shares were transferred to the CRT, the CRT trustee is now a co-shareholder with fiduciary duties that may impose a different agenda;
- Requirement to obtain additional updated qualified appraisals or valuations by an independent trustee; and/or
- Unanticipated delays in selling the stock will increase the possibility that a self-dealing transaction may occur.

Re-electing S-Status by a Subsequent Purchaser

A common concern raised when the S-election is terminated is the ability of the new ownership to re-elect S-status following the purchase of the corporation. The general rule is that a company may not re-elect S-status until five years after the termination of the S-election.[112] The IRC permits an early re-election if the Treasury Secretary consents.[113] The regulations provide that consent generally should be granted, when more than 50% of the stock in the company is owned by persons that were not shareholders at the time the S-election was previously terminated. The new shareholders must formally petition the IRS for its consent to re-elect S-status, but the ruling history has generally been favorable so long as the requirements of the regulations have been met.[114]

[112] See IRC §1362(g).
[113] See IRC §1362(g).
[114] See Treas. Reg. §1.1362-5(a). See also PLRs 9002043, 9003057, 9009015, 9014059, 9027015, 9045006 and 9050050, among others.

Technique #2 -- Charity Avoids Liability for a Gift of a Business

William Jackson, a successful entrepreneur, wants to make a $1.35 million gift (45% of his interest in Financial Services, Inc.) to create a donor-advised fund account (DAF) endowing his favorite charity. The owner of a number of closely held businesses, he approaches the charity about a contribution of closely-held stock in Financial Services, Inc. Although several competitors are willing to buy the $3 million company, the charity, after careful consideration, expresses reservations about accepting a gift of unmarketable securities.

William's financial advisor offers an alternative solution to this dilemma. He suggests contributing the stock to a two-year term, tax-exempt, net income charitable remainder trust (CRT) naming the DAF as the remainder beneficiary. This solution shifts the burden of selling the asset away from the charity and gives the CRT trustee a full two years to negotiate the sale of the business with only a modest reduction in William's income tax charitable deduction.

William receives a $1,220,886 charitable income tax deduction, which is 90% of the value of the contributed stock. He avoids $364,500 in immediate capital gain taxes he would have paid had he sold the stock and made a cash gift of the proceeds. He removes $1.35 million from his estate reducing his estate tax burden. In addition to his tax savings, he accomplishes his goal of creating an endowment for his favorite charity.

Additional Comments:

This scenario provides a way that charities can receive gifts from business owners even if your CFO refuses to take title to a closely-held business. By inserting the CRT in the process, the following is a short list of benefits:

- Your donor can still make their dream charitable gift with shares of his/her business.
- Because the donor can serve as the CRT's trustee, she can be in charge of the sales negotiation.
- Your organization will still receive the bulk of or all of the sales proceeds.
- By limiting the noncharitable term to two years, the donor's income tax deduction benefit is still 90% the same as an outright gift.

This option could equally apply to gifts of other assets that your CFO refuses to accept such as real estate or collectibles.

Technique #3 -- Corporation Redeems Stock Given to a CRT

If a corporation has sufficient cash reserves and/or cash flow from operations, it may be desirable for a principal shareholder to contribute stock in the corporation to a CRT. Subsequently, the corporation's board of directors can extend a redemption offer to all shareholders. This technique can be a powerful method for funding an exit strategy and/or business succession plan using the tax-advantaged leverage of a CRT.

Example: Jerry and Tanya Simmons, both age 63, have owned and operated Simmons Industries, Inc. (SII) for the past 40 years. They have two children, JJ and Samantha, who are actively involved in the business and will succeed into ownership and senior management positions upon the Simmons' retirement.

SII is currently valued at $8,000,000 and has 1,000,000 shares outstanding. SII currently has $1.5 million in cash and (even in this economy) is producing free cash flow in excess of $600,000 per year.

Jerry and Tanya are ready to phase out of their participation in the company and turn over the reins to JJ and Samantha. Their planning team recommends that Jerry and Tanya implement a plan that involves occasional transfers of SII stock to a CRT followed by the redemption and retirement of that stock.

To kick-start the plan, Jerry and Tanya give $750,000 (93,750 shares) of SII stock each to JJ and Samantha. Jerry and Tanya will use their gift tax annual exclusions and lifetime exclusion to shelter these gifts from gift tax. Jerry and Tanya then transfer 187,500 shares of SII stock (approximate value equal to $1,500,000) to a lifetime CRT for Jerry and Tanya's benefit. After this transfer, the ownership structure of SII is as follows:

Table 3-1

Shareholder	Number of Shares	Percent of Ownership
Jerry and Tanya Simmons	625,000	62.500%
JJ Simmons	93,750	9.375%
Samantha Simmons	93,750	9.375%
Jerry and Tanya Simmons CRUT	187,500	18.750%
Total	**1,000,000**	**100.00%**

After the transfer, Jerry and Tanya, in their position as majority shareholders, cause SII to extend an offer to all shareholders to redeem up to 187,500 shares at their fair market value. The CRT trustee is the only party to accept the redemption offer. The shares are redeemed and subsequently retired. The new ownership structure is as follows:

Table 3-2

Shareholder	Number of Shares	Percent of Ownership
Jerry and Tanya Simmons	625,000	76.92%
JJ Simmons	93,750	11.54%
Samantha Simmons	93,750	11.54%

Shareholder	Number of Shares	Percent of Ownership
Jerry and Tanya Simmons CRUT	0	0.00%
Total	**812,500**	**100.00%**

Over the next several years, Jerry and Tanya contribution additional shares of stock to the CRT followed by corresponding redemptions by the company. The number of shares transferred and redeemed varies according to SII's available cash. At the end of 10 years, the ownership structure is as follows:

Table 3-3

Shareholder	Number of Shares	Percent of Ownership
Jerry and Tanya Simmons	231,009	55.20%
JJ Simmons	93,750	22.40%
Samantha Simmons	93,750	22.40%
Jerry and Tanya Simmons CRUT	0	0.00%
Total	**418,509**	**100.00%**

In addition, approximately $6,000,000 has been transferred to Jerry and Tanya's CRT.

While the most prudent CRT format to select when transferring unmarketable stock of a family business to a CRT is the NIMCRUT or Flip-CRUT, Jerry and Tanya's CRT is a standard charitable remainder unitrust (SCRUT) because the mechanics of a stock redemption under this scenario do not require negotiations with an outside party.

In addition, the advisors are careful to ensure that the CRT's remainder interest must be paid to a public charity so that Jerry and Tanya may claim an income tax deduction based on the fair market value of the SII stock transferred to the CRT.

In order to substantiate the income tax deduction and comply with the requirements of the limited exception to the self-dealing rules for corporate reorganizations (discussed below), a qualified appraisal is obtained valuing each transfer and redemption.

As a result, the CRT's tax-exempt status will shelter the tax consequences of each redemption. Jerry and Tanya receive an income tax deduction for each contribution to their CRT, retain a unitrust interest for life, remove the value transferred to their CRT from their taxable estate; and, over time, JJ and Samantha's ownership percentages grow. At the death of the survivor of Jerry and Tanya, a significant gift will be made to charities in their community.

Additional Considerations Unique to Stock Redemptions

Initiating the Plan

In many stock redemption plans, a key component is the eventual transfer of control to children or key employees. In order to achieve this goal, the children or key employees must begin with a fractional interest in the corporation. Where shares are transferred to children, the clients must use annual exclusion gifts, lifetime exclusion gifts or even gifts on which the clients owe gift taxes to "prime the pump." Where children are employed by the corporation or key employees are the intended successor owners, nonqualified stock options may be granted with cash bonuses paid to fund the exercise of the options.

Tax Treatment of Redemption Proceeds

If stock is treated as redeemed for income tax purposes, then the transaction may be treated as the sale or exchange of a capital asset and may qualify for capital gain treatment (so long as the stock otherwise meets the definition of a capital asset). In the following cases, a redemption is treated as payment in exchange for the stock:

1. A redemption that is "substantially disproportionate" with respect to the redeeming shareholder,[115]
2. A complete redemption of all of a shareholder's stock in the corporation,[116]
3. A redemption that is "not essentially equivalent to a dividend,"[117]
4. A redemption of stock held by a noncorporate shareholder, in partial liquidation of the distributing corporation,[118] or
5. A redemption of a decedent's stock to pay death taxes.[119]

However, in most cases involving a family business, constructive ownership rules[120] will prevent stock redemptions from a CRT from qualifying for capital gain treatment until the donor's (and related party's) ownership position declines below 50%. As a result, redemptions of a closely-held corporation's stock are generally treated as a distribution to the shareholder. Distributions to shareholders are taxed first as a dividend to the extent of the corporation's earnings and profits, next as a return of the shareholder's tax basis to the extent of the shareholder's tax basis and finally as long-term capital gain to the extent of the remainder of the distribution.[121] A distribution classified as a dividend should be eligible for treatment as a qualified dividend.[122]

Avoiding Self-Dealing

In general, when a substantial contributor to a CRT is a greater than 35% shareholder of a corporation, the corporation is a disqualified person with respect to the CRT.[123] Therefore, barring an exception, the corporation's redemption of stock from the CRT is a prohibited act of self-dealing.[124] However, there is a noteworthy exception for many types of corporate reorganizations.[125] In order for a redemption offer to qualify for this exception:

- The redemption offer must be made to all holders of the company's outstanding shares of the same class as is held by the CRT;
- The offer to each shareholder must contain the same terms, and

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[115] See IRC §302(b)(2).
[116] See IRC §302(b)(3).
[117] See IRC §302(b)(1).
[118] See IRC §302(b)(4).
[119] See IRC §303(a).
[120] See IRC §318(a)(3)(B)(i).
[121] See IRC §301(c).
[122] See IRC §1(h)(11)(B) for the definition of a qualified dividend.
[123] See IRC §4946(a)(1)(E) and Treas. Reg. §53.4946-1(a)(1)(v). Applicable attribution rules require the aggregation of company stock owned by other disqualified persons related to the substantial contributor in determining the whether the 35% threshold is exceeded.
[124] See IRC §4941(d)(1)(A) and Treas. Reg. §53.4941(d)-2(a)(1).
[125] See IRC §4941(d)(2)(F) and Treas. Reg. §53.4941(d)-3(d).

- The CRT must receive no less than fair market value.

The regulations further explain that:

> [A]ll of the securities are not subject to the same terms unless, pursuant to such transaction, the corporation makes a *bona fide offer on a uniform basis to the foundation and every other person who holds such securities*. [emphasis added][126]

The IRS has not addressed the computation of fair market value in this context, although the Service has noted a number of times that payment of fair market value is a necessary condition to qualify for the exception.[127] As highlighted above, the regulation's applicable standard is a "bona fide offer on a uniform basis" to each shareholder. It is the author's opinion that any method of determining the fair market value per redeemed share that is not determined by the dividing the fair market value of the entity by the number of outstanding shares is likely to be challenged on the premise that the offered share price is not a bona fide offer on a uniform basis. Stated differently, redeeming the CRT's interest using a value that assigns a minority interest discount or lack of marketability discount to the CRT's interest is likely to fail the bona fide offer on a uniform basis test because the CRT will arguably receive less than fair market value.

The redemption of stock in exchange for a note or other extension should be avoided in order to prevent a prohibited act of self-dealing.[128]

Assignment of Income—Issues Specific to Corporate Redemptions

A number of cases, most notably *Palmer v. Comm.*,[129] have considered whether a charitable gift followed by a stock redemption resulted in the Assignment of Income from the donor to the charitable recipient. As noted elsewhere in this paper, the IRS ultimately acquiesced[130] to the result in *Palmer* and concluded that the proceeds from the redemption of stock will not be an Assignment of Income to the donor where at the time of the gift the charitable recipient:

- Is not legally bound to surrender the shares for redemption; and
- Cannot be compelled to surrender the shares for redemption.

Because the redemption technique discussed in this strategy involves the same parties on both sides of the transaction, great care should be exercised to observe not only the substance of the transaction, but also the form. Properly structuring the form of transaction is the best method for documenting that the trustee is not legally obligated to surrender the shares for redemption nor under compulsion to surrender the shares.

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[126] See Treas. Reg. §53.4941(d)-3(d)(1).
[127] For example, see PLR 200230004 and PLR 200720021.
[128] See IRC §4941(d)(1)(B) and Treas. Reg. §53.4941(d)-3(d)(2), Example (2).
[129] See *Palmer v. Comm.,* 62 T.C. 684 (1974).
[130] See Rev. Rul. 78-197, 1978-1 CB 83.

Technique #4 -- Corporation Redeems Stock Given to a DAF

Brent & Andrea Prichard have owned and operated BAP, Inc. (BAP) for the past 40 years. They have two children, Adam and Delaney, who are actively involved in the business and will succeed into ownership and senior management positions when Brent & Andrea retire. BAP is currently valued at $8,000,000 and has 1,000,000 shares outstanding. BAP also holds $1.5 million in cash.

At age 63, Brent & Andrea are ready to reduce their participation in the company and turn over the reins to Adam and Delaney. Their planning team recommends that Brent & Andrea implement a plan that includes a gift of BAP stock to a Donor-Advised Fund (DAF) followed by a redemption and retirement of the stock.

Brent & Andrea transfer $1 million of BAP stock (125,000 shares) to Renaissance Charitable Foundation Inc. (RCF) to create a DAF known as the Prichard Family Fund. After the transfer, BAP makes an offer to all shareholders to redeem up to 125,000 shares at fair market value. RCF is the only party that accepts the redemption offer. BAP redeems the shares and retires them.

Based on a Qualified Appraisal, Brent & Andrea claim a federal income tax charitable deduction of $1,000,000, reduce their federal estate, and retain the permanent right to recommend from time to time that RCF make grants from the Prichard Family Fund to museums and their other favorite charities.

Technique #5 -- DAF Sells Corporate Stock to the Donor's Son

Lucy Lee owns 100% of Lee Metals, Inc. and is planning her retirement. Her attorney, Donna Sanders, describes various options for selling or transferring the company to her son Jeff. Lucy is dismayed to learn that many of the strategies involve her paying either capital gain or gift tax.

As part of their conversation, Donna asks Lucy, “Are there any charities you regularly support?” Lucy regales Donna with many humorous stories about her friends at the Garden Club and the Arts Council. Hearing this, Donna describes how Lucy can create a long-term giving account that supports those charities and could also sell some of the company shares to Jeff without capital gain or gift tax.

As part of her overall plan, Lucy gives 10% of her shares to Renaissance Charitable Foundation (RCF) to create a Donor-Advised Fund (DAF) known as the Lucy Lee Fund. To claim her income tax charitable deduction for this gift, Lucy acquires a Qualified Appraisal of the contributed shares. Donna explains that while Lucy cannot force RCF to sell the shares to Jeff, RCF can sell the shares (for no less than fair market value) to any party including someone related to Lucy. Further, once the Lucy Lee Fund holds liquid assets, Lucy will be able to make grant recommendations to support her favorite charities throughout the United States from time to time.

Lucy is pleased to avoid capital gain and gift tax and she likes the extra income tax deduction. But the two benefits Lucy likes most about giving some of her company to create the Lucy Lee Fund are that her son Jeff now owns a portion of the business and Lucy has established a lasting fund that will support the Garden Club and Arts Council.

Technique #6 -- Corporation Creates a CRT

CRTs are often proposed when a business entity is to be sold. As noted above in the section entitled "Asset Sale vs. Stock Sale", buyers frequently prefer to purchase the assets of a corporation rather than the stock of the corporation. An asset sale generally produces unfavorable tax results for the business owner. One solution to this dilemma is for the corporation to create a CRT and transfer some of the corporation's assets to the trust. The IRS has ruled that both C-corporations[131] and S-corporations[132] are permissible settlors of a CRT.

Example: Debbie Hoyt, age 65, owns a strip mall that is in the path of a planned redevelopment project. Estimates are that Debbie's property is worth $7 million. Many years ago, Debbie's tax advisor counseled her to transfer the strip mall to a C-corporation, Hoyt Realty Corporation (HRC). HRC's depreciated tax basis in the property is $60,000. Debbie's overall net worth is $10 million not including her personal residence.

Debbie is ready to relinquish the management responsibilities associated with the property and is looking forward to funding her retirement with the proceeds from the sale of the property. In addition, Debbie wants to endow a scholarship at the local community college.

The developer wants the real estate and does not want to purchase the stock of HRC. This creates a problem for Debbie in that if HRC sells the property to the developer, then HRC will owe a tax. Furthermore, when Debbie liquidates HRC or withdraws money from HRC, she will owe an additional tax. Therefore, Debbie is now faced with a double tax on the proposed sale of the property to the new developer.

In conjunction with Debbie's other financial and estate planning goals and after confirming that there is no outstanding debt on the strip mall, Debbie's gift planning team recommends that HRC create a CRT and transfer a 1/7th fractional interest to the CRT. HRC will be the income beneficiary of the CRT and the CRT will be designed to terminate at the end of 20 years. HRC obtains a qualified appraisal for its transfer of a 1/7th fractional interest in the strip mall to a CRT, in order to substantiate its charitable income tax deduction.

The gift planning team further recommends that the CRT utilize a flip provision to minimize the risk associated with a delayed sale. Debbie's attorney is careful to ensure that the CRT's remainder interest must be paid to a public charity.

As a result, approximately 14% of the gain on the sale of the strip mall is sheltered from immediate taxation. HRC receives a current income tax deduction, a unitrust interest for the next 20 years and indirectly the value transferred to the CRT is removed from Debbie's taxable estate. After expiration of the 20-year term, the local community college will receive funds to create an endowed scholarship in Debbie's name.

[131] See PLRs 8102093 and 9205031.
[132] See PLRs 9340043 and 200644013.

Additional Considerations Where a Corporation Creates and Funds the CRT

Selection of the Income Beneficiary

The Code and the regulations permit any person[133] to be named as the income beneficiary of a CRT so long as at least one beneficiary is not a charitable organization.[134] When there is a valid business purpose, it is possible to name someone other than the corporation as the income beneficiary of a CRT created by a corporation (e.g., a key employee or owner of the business).[135] However, the IRS held in PLR 200203034 that, in the case of an S-corporation that established a CRT and named a person other than the corporation as the income beneficiary without a valid business purpose, the trust failed to meet the statutory definition of a trust and therefore did not qualify as a CRT.

A second consequence of naming a person other than the corporate donor as the income beneficiary is that the corporation will be treated as having made a constructive distribution to that person.[136] Depending on the relationship of the income beneficiary to the corporation and/or its owners, this constructive distribution may be classified as a dividend, compensation and/or a gift.

As a result, corporations that create CRTs are well-advised to name themselves as the sole income beneficiary.

Selection of Trust Term

When a corporation is the sole income beneficiary of a CRT (as recommended in the previous section), the Code requires that the trust term be a term certain not to exceed 20 years.[137] While the maximum term is 20 years, consideration should be given to shorter terms. Often, marrying shorter terms with higher payout rates will produce attractive results for both the corporation and the charitable beneficiaries.

Claiming the Income Tax Deduction

Contributions by C-Corporations. Where a C-corporation is the settlor of a CRT, the contribution deduction is claimed by the corporation, not the shareholders of the corporation.

Contributions by S-Corporations. As a pass-through entity, when an S-corporation contributes assets to a CRT, the resulting charitable deduction passes through to the shareholders in proportion to their ownership interest.[138] A shareholder's ability to use her

[133] IRC §7701(a)(1) defines a "person" as an individual, trust, estate, association, company, corporation and partnership.
[134] See IRC §664(d)(1)(A) and Treas. Reg. §1.664-2(a)(3)(1) for annuity trusts. See IRC §664(d)(2)(A) and Treas. Reg. §1.664-3(a)(3)(1) for unitrusts.
[135] A discussion of valid business purposes for creating a CRT that names an individual as an income beneficiary is beyond the scope of this paper. However, an example might include using a CRT as an alternative form of executive compensation.
[136] See Treas. Reg. §1.671-2(e)(4).
[137] See IRC §664(d)(1)(A) for annuity trusts and IRC §664(d)(2)(A) for unitrusts.
[138] Charitable deductions made by an S-corporation are reported to shareholders on Schedule K-1 in Box 12, Other Deductions. Codes A – G are reserved to describe for the shareholder the type of charitable recipient and the type of property contributed.

deduction is limited to her tax basis in the corporation.[139] To the extent that the shareholder has insufficient tax basis in the corporation to claim the deduction, that portion of the charitable contribution deduction is suspended until the shareholder has sufficient tax basis.[140, 141]

Further, the S-corporation basis reduction rule of IRC §1367(a)(2)(B) generally requires the reduction of basis by the value of the property contributed. In addition, unrealized gains in the contributed property do not increase a shareholder's S-corporation basis. Therefore, charitable contributions of appreciated property by an S-corporation are generally subject to adverse treatment.[142]

If there is sufficient basis to claim a charitable contribution deduction, then the individual shareholder is subject to the IRC §170(b) adjusted gross income limitations on deductibility and the five-year carryover period of IRC §170(d).

Where appreciated property is contributed by an S-corporation to a private foundation (or to a CRT in which a private foundation *could* be a remainder beneficiary), the Schedule K-1 provided to each shareholder should clarify the tax status of the charitable recipient and report the adjusted tax basis of the contributed property so that each shareholder can properly apply the limitation that reduces the deductible amount to the adjusted tax basis of the contributed property.[143]

Qualified Appraisal Required. Where otherwise required, a corporation (C- or S-) must obtain a qualified appraisal to substantiate the value of the property contributed.[144] In determining whether a qualified appraisal is required for gifts by a pass-through entity such as an LLC, partnership, or S-corporation, the dollar thresholds noted above are applied at the entity level. Where an otherwise required qualified appraisal is not obtained or is deemed deficient, the deduction is denied at the member, partner, or shareholder level.[145]

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[139] See IRC §1366(d)(1).
[140] See IRC §1366(d)(2).
[141] Through December 31, 2009, in determining the amount of an S-corporation's contribution of appreciated property an S-corporation shareholder is permitted to deduct, an S-corporation shareholders is only required to reduce the basis of his or her S-corporation stock by his or her pro-rata share of the S-corporation's basis in the appreciated property. The deductible amount is then calculated by multiplying the shareholder's pro rata share of the fair market value of the contributed property by a fraction whose numerator is the amount by which the basis in the S-corporation stock was reduced and whose denominator is the shareholder's pro-rata share of the basis in the appreciated property. Any unused portion of the deduction is then carried over under the normal rules. See the last paragraph of IRC §1367(a)(2).
[142] The Pension Protection Act of 2006 temporarily provided relief by altering the basis reduction rule as noted in the final paragraph of IRC §1367(a). For charitable contributions of appreciated property made by S-corporations during 2006 and 2007, a shareholder was permitted to reduce her basis by an amount equal to her pro-rata share of the corporation's adjusted basis in the contributed asset. This permitted an S-corporation shareholder to deduct more of her S-corporation's charitable contributions of appreciated property. See IRC §1367(a) and Revenue Ruling 2008-16.
[143] See IRC §170(e)(1).
[144] See IRC §170(f)(11)(A). This requirement was extended to C-corporations by the American Jobs Creation Act for gifts after June 3, 2004.
[145] See IRC §170(f)(11)(G).

Continued Existence of the Corporation

C-Corporation. As noted above, where a C-corporation is the settlor of a CRT, it should almost always be the only income beneficiary of the CRT. As a result, the C-corporation should continue in existence for the duration of the term of the CRT. Distributions from the CRT should be paid directly to the C-corporation. The CRT will also issue a Schedule K-1 each year, which will define the tax character of the CRT distributions received by the C-corporation for use in preparing its annual income tax return.

If the shareholders wish to receive cash, then the directors of the corporation must declare a dividend to all shareholders, make shareholder loans, redeem stock or utilize other methods commonly used to transfer cash from a corporation.

Where the majority of the income received by the corporation is from the CRT, the corporation may be classified as a personal holding company.[146] If a corporation is a personal holding company, then it is subject to a 15% penalty tax[147] on its undistributed personal holding company income.[148] Two common solutions to avoid the imposition of this penalty tax are:

1. Annually distribute all personal holding company income; and
2. Where the corporation is otherwise eligible, elect S-status.

Pursuit of the second option may be frustrated if the corporation has significant undistributed accumulated earnings and profits at the time the S-status is elected. Where it is not possible to distribute the accumulated earnings and profits prior to electing S-status, the S-election may automatically terminate due to excess passive investment income. (See the discussion of "Excess Passive Investment Income" below).

S-Corporation. As noted above, where an S-corporation is the settlor of a CRT, it should almost always be the only income beneficiary of the CRT. As a result, the S-corporation should continue in existence for the duration of the term of the CRT. Distributions from the CRT should be paid directly to the S-corporation. The CRT will issue a Schedule K-1 each year, which will define the tax character of the CRT distributions received by the S-corporation. This information is then used by the S-corporation in preparing the Schedule K-1s issued to its shareholders. With respect to the CRT distributions, the tax character of S-corporation distributions to the shareholders should match (substantially) the tax character reported by the CRT to the S-corporation.

Dividends Received Deduction (C-Corporations <u>only</u>)

Dividends reported to a C-corporation on a CRT Schedule K-1, may be eligible for the dividends received deduction of IRC §243.[149] Not all dividends are eligible for the deduction under IRC §243 nor are all dividends deductible to the same degree. The CRT trustee and/or administrator should provide sufficient detail on the Schedule K-1 issued

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[146] See IRC §542.
[147] See IRC §541.
[148] Personal holding company income is generally defined to include dividends, interest, rents, royalties and annuities along with some other unusual items of income. See IRC §543(a).
[149] See PLR 8102093 in which a C-corporation funded a CRT and named itself as the CRT's income beneficiary. The C-corporation was allowed to claim the Dividends Received Deduction under IRC §243.

to the C-corporation so that the corporation can substantiate the character of the dividends it receives from the CRT.

Gifts of "Substantially All" of the Assets of a Corporation to a Charitable Organization

When considering the transfer of "substantially all"[150] of the assets of a corporation to a CRT, the non-recognition rules under IRC §337(d) should be reviewed. The regulations provide that when a corporation either converts to an exempt organization or contributes substantially all of its assets to an exempt organization, the transfer is treated as a deemed sale by the corporation immediately prior to the conversion or transfer.[151] The regulations specifically include CRTs in the list of exempt organizations for which this rule applies.[152]

Some practitioners believe a case can be made that a corporation's retention of an annuity interest or unitrust interest in a CRT ameliorates the concern over the transfer of substantially all of its assets. For example, if a corporation creates a CRT and retains a unitrust interest valued at 85% of the contribution amount, then the argument is that the corporation has not transferred substantially all of its assets, but simply changed the form of its assets.

Application of Built-in Gains Tax (S-Corporations)

For S-corporations that were previously C-corporations, the IRC provides a special rule requiring the recognition of a corporate-level tax upon the sale of assets owned by the corporation at the time of conversion. This corporate-level tax is known as the "built-in gains tax," or BIG tax. The rule applies to sales that occur within a 10-year recognition period that begins on the date the corporation elects to convert to an S-corporation.[153]

The IRS has ruled that the transfer by an S-corporation to a CRT of property that would otherwise be subject to the BIG tax would not trigger recognition of the built-in gain, nor would the subsequent sale of the property by the trust cause the S-corporation to recognize the built-in gain.[154]

However, to the extent the trust would be required to distribute gain arising from the disposition of built-in gains property to satisfy the annuity or unitrust amount, the distributed built-in gains would be subject to the BIG tax at the S-corporation level for the remainder of the original 10-year recognition period.

Excess Passive Investment Income (S-Corporations)

If during three consecutive taxable years, an S-corporation has accumulated earnings and profits and receives more than 25% of its gross receipts from passive sources, then its S-election will automatically terminate.

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[150] The term "substantially all" is not defined in the Code or regulations. However, in Rev. Proc. 77-37, the IRS stated that for purposes of issuing an advance ruling, transfer of 90% of the fair market value of the net assets and 70% of the fair market value of the gross assets would constitute "substantially all."
[151] See Treas. Reg. §1.337(d)-4(a)(1) and (2).
[152] See Treas. Reg. §1.337(d)-4(c)(2)(ii).
[153] See IRC §1374(d)(9).
[154] See PLR 200644013.

The regulations provide that the earning and profits that count for this purpose must be derived from a period when the S-corporation was previously a C-corporation.[155] Therefore, this obstacle is not applicable to an S-corporation that never was a C-corporation or has distributed all of the earnings and profits earned while it was a C-corporation.

If an S-corporation holds accumulated earnings and profits and chooses to create a CRT, it must either distribute the accumulated earnings and profits or actively manage the character of its gross receipts (including the CRT distributions) to remain below the 25% threshold. Failure to successfully navigate this obstacle will result in the loss of the S-election and the double taxation of at least the CRT distributions, if not other corporate earnings.

Passive investment income generally includes gross receipts derived from dividends, interest, rents, royalties, annuities and capital gain.[156] Note that most CRT distributions are comprised of these categories. Therefore, if there are undistributed earnings and profits, this is an important concern.

[155] See Treas. Reg. §1.1362-2(c)(3).
[156] See IRC §1362(d)(3)(C).

Appendix A: Qualified Appraisal Requirements

The Pension Protection Act of 2006 included a number of provisions that affect both qualified appraisers and qualified appraisals. Treasury and the IRS issued Notice 2006-96 to provide transitional guidance pending the release of Final Regulations.[157] The IRS issued Proposed Regulation §1.170A-16 on August 7, 2008; however, the Regulation is still not yet final. Pending finalization of these Regulations, Notice 2006-96 provides the hierarchy for determining the applicable requirements of a Qualified Appraisal using the longstanding Qualified Appraisal regulations under §1.170A-13 to the extent they are not inconsistent with IRC §170(f)(11).[158]

Qualified Appraisal Defined
A qualified appraisal is an appraisal document that:[159]

1) relates to an appraisal of the contributed property made no earlier than sixty (60) days before the contribution date, nor later than the due date of the tax return (including extensions) on which an income tax charitable deduction is first claimed;
2) is prepared, signed and dated by a “qualified appraiser” (as described below);
3) does not involve a prohibited appraisal fee (as described below); and
4) includes the required elements described below.

Required Elements of a Qualified Appraisal
A qualified appraisal must include the following information:[160]

1) a description of the property that is in sufficient detail to confirm that the appraised property is the contributed property;
2) in the case of tangible property, its physical condition;
3) the date (or expected date) of the contribution;
4) the terms of any agreement or understanding (or anticipated agreement or understanding) by or on behalf of the donor or donee that relates to the use, sale or other disposition of the property;
5) the name, address, taxpayer ID number or other identifying number of the appraiser, together with the capacity in which the appraiser is acting, e.g., as an individual, an employee, a partner in a partnership, etc.;
6) the appraiser’s qualifications, including a statement of background, experience, education and membership in any professional appraisal associations;
7) a statement that the appraisal was prepared for income tax purposes;
8) the date (or dates) the property was appraised;

[157] See Notice 2006-96, 2006-46 IRB 902, 10/19/2006.
[158] See Notice 2006-96, Sec. 3.02(1), 2006-46 IRB 902, 10/19/2006.
[159] See Treas. Reg. §1.170A-13(c)(3)(i).
[160] See Treas. Reg. §1.170A-13(c)(3)(ii).

9) the method used to establish fair market value;
10) the specific basis for the valuation, e.g., comparables, statistical sampling, etc.; and
11) the appraised fair market value on the date of the contribution.

Qualifications of a Qualified Appraiser[161]
A qualified appraiser must:

1) perform appraisals on a regular basis or hold himself/herself out to the public as an appraiser;[162]
2) regularly perform appraisals for compensation;[163]
3) be qualified to make appraisals of the type of property at issue because of the appraiser's personal qualifications;[164]
4) have earned an appraisal designation from a recognized professional appraiser organization or otherwise met minimum education and experience requirements;[165]
5) have verifiable education and experience in valuing the type of property being appraised;[166] and
6) not be a member of the class of persons who are statutorily disqualified from making an appraisal in a given case.[167]

In addition, the appraiser must include in the appraisal document a written declaration[168] attesting to these qualifications and affirming that he/she understands that an intentionally false or fraudulent overstatement of the value of the property may subject the appraiser to federal civil penalties and that the appraiser may have appraisals disregarded.[169]

Caution: If the donor has knowledge of facts that would cause a reasonable person to expect the appraiser to falsely overstate the value of the donated property, then the appraiser will be deemed to be disqualified, thereby invalidating the appraisal.[170]

Persons Who Cannot Appraise a Particular Property
The following persons are not permitted to appraise a particular property:

1) the donor or taxpayer who is claiming the income tax charitable deduction for the contribution of the property being appraised;[171]

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161 See Treas. Reg. §1.170A-13(c)(5)(i).
162 See Treas. Reg. §1.170A-13(c)(5)(i)(A).
163 See IRC §170(f)(11)(E)(ii)(II).
164 See Treas. Reg. §1.170A-13(c)(5)(i)(B).
165 See IRC §170(f)(11)(E)(ii)(I).
166 See IRC §170(f)(11)(E)(iii)(I).
167 See Treas. Reg. §1.170A-13(c)(5)(i)(C).
168 See Treas. Reg. §1.170A-13(c)(5)(i).
169 See Treas. Reg. §1.170A-13(c)(5)(i)(D). The penalties are for aiding and abetting an understatement of tax liability. See IRC §6701.
170 See Treas. Reg. §1.170A-13(c)(5)(ii).
171 See Treas. Reg. §1.170A-13(c)(5)(iv)(A).

2) the person who sold, exchanged or gave the property to the donor or any person who acted as the agent for the transferor or for the donor with respect to such sale, exchange or gift, unless the property was donated within two months of its acquisition and the appraised value does not exceed the acquisition price;[172]
3) the donee of the property;[173]
4) any person employed by the donor, donee or any person described in item two above;[174]
5) any person who is related to any of the above-listed persons via the attribution rules of IRC §267(b), e.g., controlled companies, husband, wife, brothers, sisters, ancestors, lineal descendants, etc., plus any such persons related to the donor's spouse;[175]
6) any appraiser who is regularly used by the donor, donee or any person described in item two above, who does not perform a majority of his/her appraisals made during his/her taxable year for other persons; [176] and
7) any appraiser who has been prohibited from practicing before the IRS during the three-year period before the appraisal date.[177]

Fees For Qualified Appraisals

No part of the fee arrangement for a qualified appraisal can be based on a percentage of the appraised value of the property.[178] However, an appraisal fee can be based on a percentage of the appraised value when all of the following factors are present:[179]

1) the appraisal fee is paid to a generally recognized Association that regulates appraisers;
2) the Association is not organized for profit and does not pay any part of its net earnings to private shareholders or individuals;
3) the appraiser does not receive any compensation from the Association or any other person for making the appraisal; and
4) the fee arrangement is not based in whole or in part on the amount of the appraised value of the donated property that is allowed as a charitable deduction.

172 See Treas. Reg. §1.170A-13(c)(5)(iv)(B).
173 See Treas. Reg. §1.170A-13(c)(5)(iv)(C).
174 See Treas. Reg. §1.170A-13(c)(5)(iv)(D).
175 See Treas. Reg. §1.170A-13(c)(5)(iv)(E).
176 See Treas. Reg. §1.170A-13(c)(5)(iv)(F).
177 See IRC §170(f)(11)(E)(iii)(II).
178 See Treas. Reg. §1.170A-13(c)(6)(i).
179 See Treas. Reg. §1.170A-13(c)(6)(ii).

Appendix B:
Adjusted Gross Income
Limitations on Income Tax Charitable Deductions

	Publicly-Supported Charities Including **Donor-Advised Funds**		**Private Non-Operating Foundations**	
Type of Contribution	Deduct	AGI Limit	Deduct	AGI Limit
Cash	Cost	60%	Cost	30%
Marketable Securities	FMV	30%	FMV	20%
Other Long-Term Capital Gain Property	FMV	30%	Cost	20%
Election to Reduce Deduction	Cost	60%	N/A	N/A
Tangible Personal Property				
Use is *Related to* Charity's Mission	FMV	30%	Cost	20%
Use is *Not Related to* Charity's Mission	Cost	60%	Cost	20%
Qualified Intellectual Property	Cost	60%	Cost	20%

Tangible Personal Property includes any touchable property. Special rules apply to cars, boats and planes.

Qualified Intellectual Property includes Patents, Copyrights, Royalties and similar property. The donor's deduction is limited to the smaller of cost basis or market value. Additionally, for Qualified Intellectual Property gifts to a publicly-supported charity, the donor may request that the charity report to the donor how much net income the charity earns from the gift during the 10 years following the gift. The donor can treat this net income as additional contributions on a sliding scale based on numbers reported by the charity to the donor and IRS on Form 8899.

Long-term Capital Gain property includes capital assets such as stocks, bonds and other assets that would yield long-term capital gain, e.g., held more than one year.

An **Election to Reduce the Deduction** is the opportunity to deduct against 60% of AGI instead of 30% of AGI in return for using cost basis instead of Market Value in determining the deduction. See §170(b)(1)(C)(iii) for other restrictions.

Special rules apply for gifts to Charitable Lead Trusts, gifts of Ordinary Income property, and gifts of Short-Term Capital Gain property.

Appendix C

Donors can use Charitable Remainder Trusts and Donor-Advised Funds to make effective gifts to the charities they want to support. CRTs and DAFs are flexible enough to be useful for any donor wishing to make a gift to charity. CRTs are flexible enough to solve a myriad of a donor's charitable, financial, and non-financial problems. A best practice is to use a CRT to accomplish multiple donor goals.

Obviously, some assets work more compatibly with CRTs and DAFs than others. For example, cash and publicly traded securities (that can be freely traded) work extremely well both as a charitable gift and as an investment by a CRT or DAF.

On the other hand, gifts of business interest such as partnership interests, LLCs and C-corporations require much greater analysis and may ultimately be the best choice of asset as a gift to the CRT or DAF.

As with any complicated gift, the donor and her advisors should thoughtfully analyze her options and the requirements to effectively make their gift via a CRT or DAF.

Despite all the work and complex details, gifts to a CRT or DAF of an interest in a small business can be the most rewarding gift that our donors ever make. We owe our best efforts to the donors who trust us with their charitable dreams.

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