Business Interests: Planning Considerations

Business owners have unusual opportunities when it comes to making gifts to The First Church of Christ, Scientist. They have the flexibility of giving from their personal assets, or of having their companies make gifts – or they can combine the two techniques by contributing ownership shares in their businesses. For many owners, much of their wealth is contained in the business (it's estimated that more than $2.5 trillion is held in private stock), so it may be their best resource for giving. Business owners typically have income tax and estate tax challenges that can be eased through charitable giving. Additionally, charitable gifts can be good for business.

The initial consideration for business owners in planning contributions is: How is my business organized? There are five general possibilities:

C Corporations are separate tax and legal entities. The corporation computes its gross income, then subtracts total deductions. Charitable gifts of corporations are deductible up to 10% of taxable income, with a five-year carryover for excess deductions. After computing tax at corporate rates, corporations subtract available credits and pay either regular tax or alternative minimum tax, whichever is higher.

S (Small Business) Corporations essentially are taxed in the same manner as partnerships, with profits and deductions (including charitable deductions) passing through directly to shareholders on a pro-rata basis. An S corporation retains all the characteristics of the corporate form, including limited liability for its shareholders. In general, S corporations are not subject to the regular corporate income tax. S corporations may have a maximum of 100 shareholders, who may consist of individuals, estates and certain trusts (not including charitable remainder trusts).

Partnerships are arrangements in which liability for income tax passes through directly to each of the individual partners who, in turn, pay tax on their respective shares of profits. Charitable deductions also are shared by the partners.

Limited Liability Companies (LLCs) are a hybrid of a corporation and a limited partnership, and are generally taxed as partnerships for federal tax purposes (taxation may be different for state income tax purposes). LLCs provide the protection against liability of a corporation without some of the restrictions of an S corporation or the corporate tax structure of a C corporation.

Sole Proprietorships are one-person firms in which the business owner and the business are treated as one and the same for state and federal tax purposes.

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Next question: Who should make the gift – the business owner or the company?

The Company as Donor: Gifts by C (Regular) Corporations

Corporations that make charitable gifts are entitled to income tax deductions up to 10% of taxable income, with a five-year carryover. It is possible that the corporation is in a higher tax bracket than the owner, or has the best assets for charitable contributions. (Compare the owner's tax results to the corporation's in deciding who should give.) There are no adverse tax results to a business owner when the company makes a charitable gift unless controlling shareholders receive economic benefit. Gifts may sometimes be deductible as business expenses, which can overcome the 10% ceiling and other charitable deduction restrictions.

Corporations can contribute cash, marketable securities, real estate, inventory, white elephant property, and options to buy stock in the company. Gifts of options will be deductible when exercised by the charity, or when the option is sold to an unrelated charity. The deduction will be the difference between the option price and the fair market value of the stock at time of exercise. Corporations can also be the creators and/or beneficiaries of charitable remainder trusts.

> *Example*: Robert's corporation owns an office building worth $1.5 million with a $300,000 adjusted basis. The corporation can transfer the property to a charitable remainder unitrust paying the corporation 5% for 20 years. The corporation can deduct about $552,000, up to 10% of its taxable income (with a five-year carryover for excess deductions). The unitrust sells the property, avoiding tax on significant capital gains, and reinvests in preferred stock from domestic corporations paying 5% annual dividends. Robert's corporation will receive about $75,000 annually from the trust. The unitrust income distributed to the corporation should qualify for a dividends-received deduction (a corporation is entitled to a special deduction from gross income for 70% of dividends received from a domestic corporation that is subject to income tax; see IRC §243), making most of the trust income tax free. Robert, as majority shareholder, directs that qualified organizations receive the trust assets in 20 years.

The Company as Donor: Gifts by "S" Corporations

S corporations can make charitable contributions, and the deductions will pass through to the shareholders on a pro-rata basis. Gifts are deductible up to the shareholders' basis in their stock. Deductions are subject to the 50%/30% contribution ceilings that apply to individuals. S corporations are also subject to the same appraisal and receipting requirements as individual donors. If the corporation contributes appreciated property, shareholders must reduce the basis in their stock by a prorated portion of the basis in the contributed property.

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Gifts by Owners of Closely Held C Corporations

Gifts of company stock. A majority shareholder of a closely held "C" corporation typically has a low basis in the shares, relative to their fair market value. Selling the shares to an individual or back to the corporation will trigger capital gains tax. However, a charitable contribution of the shares does not cause the realization of capital gain, and the donor can deduct the fair market value of the shares on the date of the gift.

> *Example*: Suppose Miss Smith owns 90% of her corporation and decides to contribute shares worth $10,000 to The First Church of Christ, Scientist. The gift of stock leaves her in full control of the business, and costs her nothing personally. In her 35% tax bracket, she saves $3,500 in income taxes and avoids all capital gains tax. The Church has no reason to keep the stock and turns it back into Smith's corporation for redemption. The corporation gives the Church $10,000 cash and retires the stock.
>
> The IRS has ruled that Miss Smith will not be considered to have received a dividend, even though she has received a substantial benefit from her corporation, so long as the Church is not *required* to turn back the shares of stock to the corporation.

Gifts of closely held stock require appraisals and filing of form 8283 if the claimed value exceeds $10,000. If the value is between $5,000 and $10,000, the donor need not obtain a qualified appraisal, but a partial appraisal form must be attached to the tax or information return. There are specific IRS rules for appraising the value of closely held stock; however, there is often great uncertainty about value and opportunity for disputes with the IRS. Among the factors to be considered in valuing closely held stock are: corporate assets, corporate earnings and future earning power, dividend policy, prospects of the company, character of management and sales of stock near the contribution date.

Gifts of C corporation stock to a charitable remainder trust. Miss Smith, instead of making an outright gift, might transfer stock worth $500,000 to a 5% net income unitrust. Miss Smith avoids capital gain on the transfer, deducts the remainder interest in the stock and receives 5% income for life, and the Church benefits when the trust ends.

Self-dealing restrictions can be avoided if fair market value is paid for the stock and the corporation offers to redeem all other stock in Miss Smith's corporation at the same price offered to the trustee. Miss Smith could *bequeath* stock in her C corporation to a charitable remainder trust and entitle her estate to an estate tax charitable deduction. The bequest is a hedge against transfer taxes: If the IRS values her corporation at a high worth, her deduction will be correspondingly high.

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Gifts of stock to a charitable lead trust. Capital gains taxes discourage gifts-followed-by-redemption to lifetime lead trusts (which are not tax-exempt trusts), but a testamentary charitable lead trust poses no such problems because stock receives a step-up in basis. What if a lifetime charitable lead trust retains the stock? Retention works in the unusual case that the stock pays regular dividends, and if that's the case then significant gift tax savings may be available. Retention also may work where the trust is structured as a grantor trust intended to provide the donor with both income tax deductions and gift tax deductions. The plan would be for the business owner to transfer stock to a lead annuity or unitrust that pays income to the Church, remainder to children. The stock is divided into two gifts – one charitable and one private – for transfer tax purposes, and the gift tax charitable deduction reduces taxable gifts to children. Furthermore, some or all of the future appreciation can pass to children free of federal transfer tax (note that capital gains taxes are still a problem when children sell).

Outright gift followed by donor's sale of corporation. Corporation owners who are considering sale of their companies can make gifts of stock to The First Church of Christ, Scientist, with all parties expecting that the Church will sell its shares to the eventual purchaser. The donor can deduct the fair market value (and avoid capital gains) so long as the Church is free to sell or not sell its shares. Donors can keep a right of first refusal as a condition of the gift, requiring the Church to offer stock for resale to the donor at fair market value before seeking other buyers. Note: It is vital that the sale not be finalized at the time the contribution is made, or else the donor will have to report capital gains on the contributed stock. What if no buyer is identified, or an expected deal falls through? The Church simply holds the shares until some future year when the company finally is sold or liquidated – perhaps upon the donor's death – and benefits at that point. It is possible that this type of asset may not ultimately be the most appropriate way to make the gift

Outright gifts followed by sale to children. The donor's children or other beneficiaries can buy back stock from the Church at fair market value, avoid gift tax (for the donor) and secure a stepped-up basis in the stock. Children might agree with the Church to purchase stock at some future date (the donor's date of death, for example), using life insurance proceeds from a policy the children purchase on their parent's life.

Outright gifts followed by liquidation. Business owners who are anticipating liquidation of their corporations have an excellent opportunity to make gifts to the Church (so long as the gifts occur before the liquidation plan is adopted). Donors who contribute stock prior to liquidation realize several benefits:

- charitable deductions for the fair market value of the stock;
- avoidance of capital gain on the stock on their individual tax returns;
- avoidance of capital gain liability to the corporation when it redeems the contributed stock, unless the redemption is made with a distribution of appreciated assets.

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Special situations. Careful planning will be required where donors wish to transfer IRC §306 stock or restricted securities subject to SEC Rule 144/145. Sec. 306 stock produces ordinary income, rather than capital gain, upon a sale, and deductions will be reduced under IRC §170(d)(1). Restricted stock, including letter stock, control stock, private-placement stock and unregistered securities, is subject to transfer rules covering volume and timing of sales of the stock (including sales by the Church), filing of information with the SEC and a joint one-year holding period for the donor and the Church.

Gifts involving employee stock options. Companies often grant employees (and owner-employees) options to purchase company stock as a form of incentive compensation. These options usually are not attractive as gifts to charity, either because they are nontransferable during life (incentive stock options) or because their exercise produces ordinary income (non-statutory stock options). On the other hand, employees who acquire stock by the exercise of stock options may find it to be a good time for charitable gifts, either outright or in trust.

ESOPs and charitable gift arrangements. Business owners who do not plan to transfer their companies to family members sometimes sell the company to their employees – an act that can trigger capital gains taxes. Another option, one that defers capital gains taxes, is a sale through an employee stock ownership plan (ESOP). An ESOP is a defined contribution plan that must meet the requirements of IRC §401(a). Contributions to the plan are tax-deductible by the employer but are not taxed as income to the participants. The majority owner can sell shares owned at least three years to the ESOP and elect to defer tax on the gain by reinvesting the proceeds in shares of domestic corporations no earlier than three months prior to the sale and no later than 12 months after the sale. Following the sale, the ESOP must own at least 30% of the outstanding stock of the company. The seller's basis in the qualified replacement stock is the same as in the shares sold to the ESOP, with gain deferred until the shares are sold. Sale to an ESOP allows an owner to diversify a portfolio that may be heavily invested in the closely held company. Here are some gift options with the replacement stock:

- CHARITABLE REMAINDER TRUST. Daphne and Bill are shareholders of a corporation that maintains an ESOP. They sold shares of the company's stock to the ESOP, reinvesting the proceeds in qualified replacement property (QRP). The couple now wishes to create a unitrust, funding it with the QRP. The trustee would be under no obligation, express or implied, to sell the QRP. Daphne and Bill asked the IRS if they would have to recognize deferred gain on the transfer of the QRP to the CRT. The IRS told the donors not to worry: Recapture rules contained in IRC §1042 do not apply to a transfer of QRP that occurs by gift, and the IRS further ruled that there will be no gain on transfer to the trust and no recapture.

- ESOP BUYS OUT CRT. Another reported use of ESOPs is for owners to transfer closely held C stock to a charitable remainder trust, make contributions to the ESOP and – without any prearrangement – have the ESOP purchase the company stock from the charitable remainder trust.

Gifts by S corporation shareholders

Charities became eligible to own S corporation stock in 1998. S corporations comprise nearly 47% of all corporations, so the potential donor pool for gifts of S stock is significant. Tax-wise, there are some disadvantages for the donee charity, because any gain on the sale or disposition of the stock will be taken into account in determining the organization's unrelated business taxable income (UBTI). Charitable remainder trusts cannot be shareholders in S corporations, but several rulings have approved transfers of S stock to charitable lead trusts. Appraisals are required for gifts of S stock valued in excess of $10,000.

Gifts by Partnerships

Partnership gifts are treated similarly to gifts by S corporations and limited liability companies (below). Deductions for contributions flow through to the partners on a pro-rata basis. Gifts of assets reduce the aggregate basis of assets owned by the partnership.

Charities are sometimes asked if they will accept gifts of limited partnership shares. Limited partnerships must have at least one general partner, typically a corporation, and at least one limited partner. The limited partners are passive investors and take no active role in the business. They are shielded from liability for partnership debts and other partnership liabilities, except to the extent of their contributions to the partnership and any additional amounts that they are obligated or may be called upon to contribute.

Gifts of partnership interest are gifts of intangible personal property, similar to giving a share of stock. Charities take whatever rights attach to the partnership interest. Fair market value will need to be substantiated with a qualified appraisal (if the value is more than $5,000). The donor's adjusted basis is likely to be low – even zero. Partnership interests may be subject to debt, which will invoke the bargain sale rules and perhaps recognition of income, and debt-burdened assets can disqualify a charitable remainder trust.

Limited Liability Companies

A limited liability company (LLC) is a partnership that limits the liability of all the organization's members (or owners) like a corporation and is taxed as a partnership. The LLC can have members that are trusts, corporations, partnerships and other organizations. There is

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no limit on the number of members that can be owners in an LLC. Most states have now adopted LLC statutes. LLCs can make gifts in the same manner as partnerships, with pass-through of deductions. Individual owners also can give LLC interests, which can be either a member (voting) interest or an economic interest.

Gifts by Sole Proprietors

Sole proprietors have no separate tax status from their position as individual taxpayers. Gifts from donors' firms are reported on the owners' personal 1040s. Gifts of part or all of a sole proprietorship to charity may be a complex and unwieldy undertaking. The charity obviously will seek to sell the business quickly, but may face unrelated business taxable income and liability issues in the interim, plus management and administrative concerns. This may be the rare situation where the donor should sell the asset and contribute the proceeds, especially if the proprietor is seeking life income from the gift. Transferring a proprietorship to a charitable remainder trust risks a confiscatory tax on unrelated business taxable income.

Gift Opportunities for Farmers and Ranchers

Farmers and ranchers may have special opportunities to assist charitable organizations. One possibility is deeding farmland or pasture to the Church but keeping lifetime use of the property. Thus, a farmer or rancher could continue to actively work the property or lease it out – keeping the income for life. Other ideas:

Charitable remainder trusts. Norm and Alice own farmland worth $800,000, but they are about to retire and none of their children intends to continue operating the family farm. They would like to sell the land and invest the sale proceeds for a good retirement income . . . but heavy capital gains taxes will have to be paid. It so happens that Norm and Alice are long-time supporters of several charities and would like to make a significant contribution. They decide to transfer the land to a charitable remainder trust that will pay them exactly $56,000 a year for the rest of their lives. Here is what Norm and Alice stand to gain, in addition to their income:

- Complete avoidance of capital gains taxes when the trustee sells the land and reinvests the proceeds;
- A charitable contribution deduction of more than $232,000 that will save them about $70,000 in their 30% tax bracket (we have assumed that Norm is 65 and Alice is 63);
- Avoidance of all gift taxes and estate taxes;
- The services of a trustee who will serve as their money manager and relieve them of investment headaches in the future.

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Outright Gifts of Crops. Farmers might consider contributing crops to charity, even though little or no charitable deduction is available. An operating farmer who gives charity crops in the form of a warehouse receipt is required to reduce any deduction by the amount of ordinary income that would be recognized if the crops were sold. In most cases, the resulting deduction would be zero because the farmer has deducted all expenses connected with raising the crops. But, by not having to recognize any income, the farmer saves both income taxes and self-employment taxes.

Family Limited Partnerships

Parents who face heavy federal estate taxes might want to consider transferring real estate or other investment assets to a family limited partnership. They would take back general and limited partnership units and give the limited partnership units to their children. Tax results? Mom and Dad pay gift tax on the transfers to the children, but at a discount – perhaps 30% – because the partnership interests are minority interest and would be hard for the children to sell to outside buyers. The family limited partnership also may reduce income taxes by diverting income to children in low tax brackets. Other strategies:

• Transfer limited partnership shares to a charitable remainder trust that benefits family members and eventually the Church. Taxable gifts to children or others are further reduced because of a future gift to charity.

• Transfer limited partnership shares to a charitable lead trust that will pay income temporarily to the Church for, say, five years, with the remainder to children. The lead trust will cause the gift to the children to be discounted even further – with the potential even to eliminate the gift tax. But one attorney suggests arranging the trust term and payout so parents pay a modest amount of gift tax. Why? To start the statute of limitations running on any gift tax audits.

The above techniques will further reduce gift or estate taxes, and provide the lasting satisfaction of advancing the work of worthwhile organizations.

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How to Proceed

If you are interested in making a gift of a business interest, please e-mail, write or call our office.

We are pleased to advise you:

1. The tax benefits of transferring shares of stock or partnership interests to the Church
2. The possibility of funding a charitable remainder trust or charitable lead trust with shares in your business
3. The general procedure for making gifts of business interests

You will need to share with us:

1. How your business is organized: C corporation, partnership, LLC, etc.
2. Your role in the company and your approximate percentage of ownership
3. Whether you are interested in an outright, immediate gift, or a gift that provides lifetime income or other benefits to you or family members
4. Whether you are anticipating sale of a business interest in the near future
5. Whether you plan eventually to transfer the business to family members or employees

You can contact our office at philanthropy@csps.com, by phone at 1-800-288-7155, extension 3288, or write to us at the address below. We look forward to hearing from you.

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