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Tax Planning for the Philanthropically Minded Business Owner

C. Wells Hall III

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Tax Planning for the Philanthropically Minded Business Owner

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I. Philanthropy and Success Go Hand In Hand

The word “philanthropy” is derived from the original Greek *filos anthropos* which means “love of my fellow man.” Giving, and taking care of the poor, is an important part of every spiritual tradition, and a principal responsibility of the Jewish, Islamic and Christian traditions.

Fortunately, American society has been blessed by the generosity of wealthy families such as the Astors, the Carnegies, the Fords, the Kelloggs, the Mellons, the Morgans, and the Rockefellers. More recently, Bill Gates and Warren Buffett have committed to leave substantial portions of their fortunes to philanthropic causes.

Philanthropy may be a means for some wealthy persons to connect with the larger issues of the world and to find an active and meaningful place in it. In any event, it is normal for a successful business person, or the patriarch or matriarch of a successful family, having attained material success and financial rewards, to seek to memorialize a commitment to philanthropy.¹

The federal income tax laws encourage charitable giving by providing a deduction for amounts contributed to qualified charitable organizations, including property transfers, subject to certain limitations. Whatever the motivation of the philanthropist, advisors to wealthy persons and families frequently encounter questions about how to achieve philanthropic purposes through various charitable planning techniques, including outright gifts to charitable causes, private foundations, charitable remainder and charitable lead trusts, and donor-advised funds.

This outline summarizes many of the tax considerations relevant to advising the successful business owner in supporting charitable initiatives through the tax advantaged structures and techniques available under existing tax law (“The Charitable Toolbox” in Section II) and lists some of the hazards that the tax-exempt advisor must anticipate (“Navigating the Charitable Minefield” in Section III). The “Case Studies” in Section IV provide a practical walk through many of the scenarios that arise when the closely held business owner decides to become a philanthropist.

¹ For an excellent discussion of the role of philanthropy in the family, family governance, and wealth preservation, see James E. Hughes, Jr., *Family Wealth—Keeping it in the Family* (Bloomberg Press, 2004).
However, this outline is not intended to be an in-depth summary of all of the tax issues that arise in connection with tax planning for the philanthropic business owner, or an analysis of all the pros and cons of the various planning techniques. Hopefully, it will provide a road map for the advisor desiring to assist closely held business client in considering charitable planning strategies and techniques.

II. The Charitable Toolbox

A. The Private Foundation (Non-operating).

A tax-exempt private foundation is an organization qualified under section 501(c)(3) of the Internal Revenue Code of 1986 (hereinafter the “Code”) to which the organizer and members of the organizer’s family (as well as any other donor) can make contributions that qualify for income, gift and estate tax charitable deductions. The most common form of private foundation is the “non-operating” foundation, the principal purpose of which is to make grants to public charities, other charitable causes, and in some case, awarding scholarships to individuals.

In fact, all exempt organizations are presumed to be private foundations unless they can establish under objective criteria that their financial support comes primarily from the general public and not from a few substantial contributors or foundation insiders.

A private foundation may be formed as a not-for-profit corporation or a charitable trust. While different state laws may affect the choice of entity, it may be easier for most practitioners to form a non-profit corporation to qualify as a private foundation, with officers, a board of directors, and by-laws to govern its affairs. Another choice is a charitable trust. Sometimes the initial board of directors of a non-profit corporation or the trustees of a charitable trust consist entirely of family members and close advisors, which can evolve over time and after the death of the principal founder, into a broader group of advisors, but still subject to appointment by the surviving family members.

The annual reporting requirements and the attention to governance involved with a private foundation suggests that unless a minimum initial contribution or series of contributions is present, there may be other more efficient alternatives for participating in charitable giving, such as the so-called “donor-advised fund,” discussed further below. Sometimes, however, it is the donor’s desire to “kick off” a program of philanthropy in which the family would become actively involved during his or her life, followed by a substantial bequest to the foundation at death.

A non-operating private foundation may be funded with a gift of cash or qualified appreciated stock, in which event the donor’s income tax charitable deduction is based on the full value of the cash or property contributed, subject to certain limitations. If the private foundation is funded with property other than cash or qualified appreciated stock, however, the donor’s deduction is based on the lesser of donor’s tax basis and the property and its fair market value. Qualified appreciated stock is defined as unrestricted, appreciated marketable securities held for

2 Unless otherwise specified, all “section” references are to the Internal Revenue Code of 1986 (the “Code”). All “Treas. Reg. §,” “Reg. §,” or “Regulation” references are to the Treasury Regulations promulgated under the Code.
12 months, for which market quotations are readily available on an established securities market. While publicly traded securities and mutual funds qualify as qualified appreciated stock, interests in a closely held business such as a corporation, partnership or limited liability company do not qualify.

The donor’s income tax deduction for a cash gift to a private non-operating foundation is limited to 30% of adjusted gross income ("AGI") for the year, and 20% of AGI for gifts of long-term capital gain property (limited to qualified appreciated stock). Excess deductions, limited by the percentage of AGI, can be carried forward for 5 years. As discussed below, more favorable deduction rules apply to gifts made to public charities and private operating foundations.

While a private foundation can be established for any recognized charitable purpose, to qualify for status as a section 501(c)(3) organization, qualified to receive contributions deductible for income, estate and gift tax purposes, a foundation must be organized and operating exclusively for “religious, charitable, scientific, literary or educational purposes.” Such purposes may include the prevention of cruelty to children or animals. With respect to a non-operating, “grant making” foundation, the founder is not required to name or limit the type of charities the foundation will benefit, nor is the founder required to limit the foundation to any particular charitable purpose. Often, the founder preserves the organization’s flexibility by adopting general charitable purposes in the organizational documents. The donor may leave separate, non-binding written guidance and recommendations for reference by future foundation directors, managers, and trustees, including the names of particular charities and purposes the founder would like for them to consider when making distributions.

As noted further below, a non-operating private foundation is subject to various excise taxes and restrictions, notably the requirement that it distribute its “net investment income” subject to a minimum of 5% of principal on an annual basis. In other words, a private non-operating foundation with assets of $1 million and net investment income of $25,000 would be required to distribute the entire $25,000 of net investment income, plus $25,000 of principal, to meet the 5% annual distribution requirement.

B. The Private Operating Foundation.

As noted above, all exempt organizations are presumed to be private foundations unless they can establish, under one of several tests, that their financial support comes primarily from the general public and not from foundation insiders or a few substantial contributors. Certain private foundations are further classified as “private operating foundations” and are entitled to more liberal contribution limits than private foundations. A private operating foundation is one which expends, on an annual basis, substantially all of its net income (or if lesser, a “minimum investment return” of 5% on its net assets) in the direct conduct of exempt activities. This means that the foundation must be engaged in the current, direct and active conduct of a program of activities in furtherance of its charitable purposes. For this purpose, gifts and grants to other exempt organizations are not considered to be direct expenditures in furtherance of a charitable purpose. Making grants and awarding scholarships to individuals does not by itself qualify as

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3 Section 170(b)(1)(F)(i) and section 4942(j)(3).
4 Section 4942(j)(3).
the active conduct of an exempt program by a private operating foundation. IRS guidelines provide that a private foundation can be classified as a private operating foundation if the grants and awards made to individuals are part of the foundation's programs or activities in a particular discipline, such as scientific research, social work, education, or the social sciences, and if payments are to individuals to encourage their involvement in the foundation's area of interest and in some segments of the activities carried on by the private operating foundation, so that the individuals, in addition to engaging in independent study, may attend classes, seminars or conferences sponsored by or conducted by the private operating foundation, or if the private operating foundation is responsible for the general direction and supervision of the social work or scientific research the individuals are paid to conduct. Since this test is "qualitative," the fact that more funds are expended in grants and awards than for the active conduct of programs does not cause a foundation to fail to qualify as a private operating foundation, as long as it maintains a significant involvement in the programs in support of which it makes grants and scholarship awards to individuals.

A foundation qualified as a private operating foundation is treated as a public charity for purposes of determining the amount of the deduction a donor is entitled to for income tax purposes. For example, total deductions for contributions to private operating foundations (and public charities) are limited to 50% of AGI, rather than the 30% limit applicable to a private non-operating foundation. Declarations for contributions of long-term capital gain property to a private operating foundation are limited to 30% of AGI. A private operating foundation is still subject to the private foundation excise tax rules, discussed further below.

C. The Supporting Organization.

A supporting organization is a public charity governed by Section 509(a)(3) of the Code, with the purpose of supporting one or more other public charities, known as the supported organization or organizations. Accordingly, a supporting organization's public charity status is "derivative."

To qualify as a supporting organization, an entity must be organized and operated exclusively to benefit certain identified public charities (the "organizational," "operational," and "relationship" tests). Further, the organization must not be controlled, directly or indirectly, by disqualified persons, such as the founders and their family members (the "disqualified persons control" test). The attractive aspect of a supporting organization, as compared as to a private foundation, is the availability of the higher public charity deduction limits. These include the higher 50% of AGI limit, and the availability of a deduction for the fair market value of appreciated long-term capital gain property, not limited to qualified appreciated stock.

There are several types of supporting organizations. A Type I organization is operated, supervised, or controlled by one or more of the public charities its supports (similar to a parent-subsidiary relationship). A Type II supporting organization is supervised or controlled in connection with one or more supported organizations (similar to a brother-sister corporate relationship). A Type III supporting organization is operated in connection with, but not controlled by one or more supporting organizations, and may be controlled by, the donor or the donor's family (other than disqualified persons a defined in Section 4946), or by foundation
A Type III supporting organization may be functionally integrated or not functionally integrated with its supported organization.

The Tax Relief and Healthcare Act of 2006 (the "2006 Act") imposed additional restrictions on supporting organizations, which had not previously been subject to the private foundation excise taxes.

Under section 4958(c)(3), if any supporting organization, whether a Type I, II or III supporting organization, makes a grant, loan, payment of compensation or other similar payment to a substantial contributor (or person related to the substantial contributor) of the supporting organization, the substantial contributor is treated as a disqualified person, and the payment is treated automatically as an excess benefit transaction, with the entire amount of the payment treated as the excess benefit. Accordingly, the substantial contributor and, in certain cases, perhaps, the organization manager, will be subject to additional tax. A substantial contributor is generally any person who contributed or bequeathed an aggregate amount of more than $5,000 to the organization, if such amount is more than 2% of the total contributions and bequests received by the organization by the close of the taxable year of the organization in which the contribution or bequest is received by the organization from such person.

Under section 6033(l), a supporting organization is now required to file an annual information return that identifies its supported organizations and demonstrates that the organization is not controlled, directly or indirectly, by disqualified persons other than managers and publicly supported organizations.

Additional provisions primarily apply only to Type III supporting organizations. On August 1, 2007, the Service announced that it anticipates proposing regulations that will require minimum payments by Type III supporting organizations that are not functionally integrated. The advance notice of proposed rulemaking describes rules being considered regarding the criteria for determining whether a Type III supporting organization is functionally integrated, the modified requirements for Type III supporting organizations organized as trusts, and the information a Type III supporting organization will be required to provide to its supported organization to demonstrate that it is responsive to the supported organization. The excess business holding rules of Section 4943 are applied to Type III supporting organizations (other than functionally integrated organizations) and certain Type II supporting organizations. The Secretary, however, has the authority not to impose the excess business holding rules in certain circumstances. Furthermore, Type III supporting organizations cannot support an organization that is not organized in the United States (subject to a transition rule). Another provision is imposed on Type III supporting organizations that require that they prove that they are

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5 Sections 509(a)(3)(B) (iii) and 509(a)(3)(c).
6 Added by Section 1242 of the 2006 Act.
7 Section 4958(c)(3)(C).
8 Added by Section 1245 of the 2006 Act.
10 Section 4943(f)(2).
11 Section 509(f)(1).
responsive to the needs or demands of the supported organization. Finally, a Type I or Type III supporting organization may actually be deemed a private foundation if it accepts any gifts from certain persons who could exert control over the supporting organization.

D. The Donor Advised Fund

The term "donor advised fund" is defined by the 2006 Act as a fund or account: (i) that is separately identified by reference to contributions of a donor or donors, (ii) that is owned and controlled by a sponsoring organization, and (iii) with respect to which a donor or any person appointed or designated by a donor (a "donor advisor") has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in the fund or account by reason of the donor’s status as a donor. A “sponsoring organization” is defined as an organization that: (i) is described in section 170(c), (ii) is not a private foundation, and (iii) maintains one or more donor advised funds.

A donor advised fund is now subject to the excise taxes and penalties applicable to private foundations, discussed further below. In addition, contributions to a sponsoring organization that is a Type III supporting organization for maintenance in a donor advised fund are nondeductible, unless the Type III organization is functionally integrated with the publicly supported organization. As noted above, a Type III supporting organization is operated merely in connection with a publicly supported organization, as contrast to a Type I or Type II supporting organization, which must be responsive to and significantly involved in the operations of the publicly supported organization.

While donor advised funds are often appropriate for many donors, in most cases they will not suit the objectives of the philanthropically minded business owner or wealthy family. Accordingly, a detailed discussion of the restrictions and limitations imposed on such funds by the 2006 Act is beyond the scope of this outline.

E. The Charitable Remainder Trust.

A charitable remainder trust is an irrevocable trust formed inter vivos or upon the death of the grantor under which a non-charitable beneficiary or beneficiaries receives an interest for life or for a period of not more than 20 years, and a charitable beneficiary receives the remainder at the end of the term. A charitable deduction for income, gift and estate tax purposes is permitted for the present value of the remainder interest that will ultimately pass to the qualified charity provided the trust meets certain criteria described further below.

A charitable remainder annuity trust ("CRAT") pays a specified annuity to at least one non-charitable beneficiary who is living when the trust is created. The annuity may be paid on an annual, semi-annual, quarterly, monthly or weekly basis. The annuity amount payable under

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12 Section 509(f)(1).
13 Section 509(f)(1).
14 Section 4966(d)(2).
15 Section 4966(d)(2)(B).
16 Section 664(d)(1) and (2).
a CRAT must be at least 5% but less than 50% of the initial fair market value of the property contributed to the CRAT.\textsuperscript{17} The charity’s interest at inception must be worth at least 10% of the value transferred to the trust.\textsuperscript{18} The annuity payable by a CRAT must be for a specified number of years (no more than 20),\textsuperscript{19} for the life or lives of the non-charitable beneficiaries, or some combination of a specified term or the life of the non-charitable beneficiaries. No amount may be paid to anyone other than the annuity beneficiary during the term of the CRAT and when the specified term ends, the remainder interest must be transferred to the qualified charity or retained by the trust for the use of the qualified charity.

A charitable remainder unitrust ("CRUT") provides for the payment of a fixed percentage, not less than 5% nor more than 50%, of the net fair market value of the assets determined annually to one or more non-charitable beneficiaries.\textsuperscript{20} The fixed percentage must be paid at least once a year during the term of the trust, which cannot have a term of more than 20 years or the life of one or more non-charitable beneficiaries.

The charitable beneficiary of a CRUT must have an interest which is at least 10% of the value of any assets transferred to the CRUT.\textsuperscript{21} No amount can be paid out other than the fixed percentage during the term of the CRUT, and at the end of the term CRUT, the entire balance of the CRUT’s assets must be paid to one or more qualified charities.

A variation of the CRUT, which pays a fixed percentage of the value of the trust assets, regardless of income, is the "net-income-with-makeup CRUT" or "NIMCRUT," which pays either the fixed percentage or the income actually received by the trust, whichever is less.\textsuperscript{22} However, if the income is less than the fixed percentage, the deficiency can be paid in a future year, as soon as the trust has income which exceeds the fixed percentage.

Another variation of the CRUT is the "flip CRUT," which changes from a NIMCRUT to a regular CRUT upon the occurrence of a specified event, such as a sale of a specific asset contributed to the CRUT and not expected to produce much income. Both NIMCRUTs and flip CRUTs are valued in the same manner as a regular CRUT for purposes of determining the income, estate and gift tax charitable deductions.

Charitable remainder trusts must not be treated as grantor trusts under sections 671 through 678, and must include certain mandatory provisions.\textsuperscript{23} Charitable remainder trusts were previously prohibited from having unrelated business taxable income under section 512. However, section 424 of the 2006 Act amended this rule. For taxable years beginning after 2006, section 664 imposes a 100% excise tax on the unrelated business taxable income of a

\textsuperscript{17} Section 664(d)(1).
\textsuperscript{18} Section 664(d)(1)(D).
\textsuperscript{19} To prevent the circumvention of the 20-year term limitation, payments to a trust are also limited to a 20-year term, provided that payments from a charitable remainder trust for the benefit of an incapacitated person may be payable over the incapacitated person’s lifetime. Rev. Rul. 76-270, 1976-2 C.B. 194.
\textsuperscript{20} Section 664(d)(2).
\textsuperscript{21} Section 664(d)(2)(D).
\textsuperscript{22} Section 664(d)(3).
charitable remainder trust. The tax-exempt status of the charitable remainder trust, however, is not affected.

Section 664(b) prescribes a historical hierarchy for determining the character of amounts paid to a non-charitable beneficiary of a charitable remainder trust. The annuity or unitrust amount is taxed as ordinary income to the extent of the trust’s current and past undistributed ordinary income. Thereafter, payments are characterized (a) as capital gain to the extent of current and past undistributed long term capital gains, (b) as other income (including tax-exempt income) to the extent of the trust’s current and past undistributed other income, and finally (c) as trust corpus. This historical hierarchy makes it difficult to funnel tax-exempt income to a beneficiary when a trust is funded with significantly appreciated property, since all recognized capital gains must be distributed before the payments can be considered tax-free income.

Notwithstanding the historical hierarchy for distributions, a charitable remainder trust can serve as an effective tax planning tool. Since the charitable remainder trust is exempt from federal income tax (until distributions are made to the non-charitable beneficiaries as a part of the annuity or unitrust amount), a donor can contribute an appreciated asset that is about to be sold to a CRAT or CRUT, reserving the right to the annuity or unitrust percentage for life (and for the life of the donor’s spouse) and the asset can be sold by the trust and the proceeds of sale reinvested without payment of any federal income taxes on the capital gains. The capital gains will be taxable to the donor or the donor’s spouse as they are distributed to the donor as a part of the annual annuity or unitrust payment.

A charitable remainder trust is considered to be a private foundation for purposes of certain restrictions placed on private foundations, pursuant to section 508(d)(2) and section 4947(a)(2). These include the taxes on self-dealing, excess business holdings, investments jeopardizing charitable purposes, and taxable expenditures.

F. The Charitable Lead Trust.

A charitable lead annuity trust (“CLAT”) or charitable lead unitrust (“CLUT”) is the reverse of the CRAT or the CRUT. In the case of a CLAT or CLUT, a fixed or variable annuity or unitrust amount is first paid to a charitable organization (the “lead” beneficiary) for a determinable period measured by a term of years or by reference to the life of one or more individuals. At the end of the term, the remainder passes outright to one or more non-charitable beneficiaries or a trust for their benefit.

A significant feature of a CLAT or CLUT from a gift and estate planning standpoint is a discounted gift (or even a non-taxable gift) to family members. The value of a gift is determined at the time the CLAT or CLUT is established and funded. Since the family member remainder persons must wait until the term to expire to realize the value of the gift, the present value of the gift is reduced. The remaining amount of cash or value of property transferred to a CLAT or CLUT is the present value of the charitable interest, and results in a charitable deduction for the grantor, provided the CLAT or CLUT is structured as a grantor charitable lead trust.

In the case of the grantor charitable lead trust, the charitable deduction is allowable “up front” for the year in which the grantor funds the CLAT or CLUT. During the term of the CLAT
or CLUT, the grantor recognizes as income the income of the CLAT or CLUT under the grantor trust rules. No further charitable deduction is allowed to the grantor even though the annuity or unitrust payments are being paid to the charity each year.

A non-grantor charitable lead trust is taxed as a complex trust under section 661. Any trust income in excess of the income tax deduction attributable to the charitable payout is taxed to the trust. The charitable income tax deduction is allowed provided the payment is required pursuant to the terms of the governing instrument. The charitable lead trust instrument will generally meet this requirement by specifying the amount of, or the method of determining the amount of, the CLAT or CLUT payments.24

A charitable lead trust is considered to be a private foundation for purposes of certain restrictions placed on private foundations, pursuant to section 508(d)(2) and section 4947(a)(2). These include the taxes on self-dealing, excess business holdings, investments jeopardizing charitable purposes and taxable expenditures.

G. Gifts of Appreciated Property.

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the fair market value of property contributed to a charitable organization. However, in the case of charitable contributions of short-term capital gain, inventory, other ordinary income property to any charitable organizations or the contribution of long-term capital gain property (other than qualified appreciated stock) to a private non-operating foundation, the deduction is limited to the basis in the property, rather than the full fair market value of the property.

1. **50% Overall Limit for Individuals.**

All charitable contributions in any tax year by an individual are subject to a limit of 50% of the donor's contribution base, which is essentially the donor’s adjusted gross income (“AGI”). Excess deductions may be carried forward for up to five years.25

For individuals, the charitable deduction is reduced, along with other allowable itemized deductions, by an amount equal to 3% of the donor's AGI in excess of $142,700 ($71,310 for a single return filed by a married individual), adjusted for inflation, for tax years beginning in 2004 and thereafter.

2. **30% Limit on Contributions by Individuals to Private Non-operating Foundations.**

Charitable contributions to private non-operating foundations by an individual are further subject to a limit of 30% of the donor's AGI in any given year.26 Excess contributions

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24 Rev. Procs. 2007-45, and 2007-46 contains annotated sample trust provisions that meet the requirements of an *inter vivos* CLAT and a testamentary CLAT.
25 Section 170(b)(1)(A).
26 Section 170(b)(1)(A) and (B).
may be carried forward for up to five years. The 30% limitation does not apply to a gift to a private operating foundation or a public charity.

3. **20% Limit on Gift of Capital Gain Property.**

Charitable contribution deductions for gifts of long-term capital gain property (held for 12 months) to private non-operating foundations are now limited to “qualified appreciated stock,” and subject to a limitation of 20% of AGI in any given year.\(^\text{27}\) Qualified appreciated stock includes unrestricted, appreciated marketable securities held for 12 months and for which market quotations are readily available on an established securities market. Charitable deductions for gifts of other capital gain property to private non-operating foundations are limited to the donor’s adjusted basis in the property.\(^\text{28}\)

Charitable contribution deductions for gifts of long-term capital gain property to public charities and private operating foundations (not limited to qualified appreciated stock) are subject to a 30% of AGI limitation.\(^\text{29}\) A donor can elect out of the 30% limitation for a gift of capital gain property to a public charity or private operating foundation by reducing the value of the gift by the long term capital gain component and limiting the deduction to the donor’s adjusted basis in the property.\(^\text{30}\)

A gift of appreciated tangible personal property is reduced by the capital gain component, unless it is to be used in connection with the exempt purpose of a public charity.\(^\text{31}\)

Contributions in excess of the 20% or 30% limitations may be carried forward by the donor for up to five years.\(^\text{32}\)

4. **Corporate Donors**

Charitable contributions by a C corporation donor are limited to 10% of the corporation’s taxable income, computed without regard to net operating loss carrybacks and capital loss carrybacks.\(^\text{33}\) Contributions in excess of the 10% limitation may be carried forward for up to ten years. Charitable contributions by S corporation partnership and limited liability company donors are passed through to the individual shareholders, partners, or members and subject to the individual limitations.

\(^{27}\) Section 170(e)(5).
\(^{28}\) Section 170(e)(1)(B)(ii); Treas. Regs. §1.170A-4(a)(2) and (3).
\(^{29}\) Section 170(b)(1)(C).
\(^{30}\) Section 170(b)(1)(C) and section 170(e)(1)(B).
\(^{31}\) Section 170(e)(1)(B).
\(^{32}\) Section 170(d)(1)(A), section 170(b)(1)(C)(ii).
\(^{33}\) Section 170(b)(2).
III. Navigating the Charitable Minefield.

A. Excise Taxes and Penalties Applicable to Private Foundations.


Section 4940 of the Code will impose an excise tax of 2% of a private foundation’s “net investment income” for each taxable year. Net investment income includes interest, dividends, rents and royalties, plus capital gains on property used for the production of such income, less expenditures for the management, conservation or maintenance of property used for the production of such income.

(a) In years when a private foundation meets the distribution requirements of section 4940(e) of the Code, the excise tax may be reduced to 1%. Qualifying distributions to accomplish one or more charitable purposes must be made by the private foundation each tax year to the extent of the average percentage payout by the private foundation for the 5 preceding tax years, to reduce the excise tax to 1%.

(b) The 2% and 1% excise tax can be avoided if the private foundation satisfies the requirements of an exempt operating foundation defined in section 4940(d) of the Code. An exempt operating foundation must satisfy specific requirements involving the active conduct of charitable activities, public support, and governance by individuals who are not “disqualified persons.”

2. Section 4941 Tax on Self-Dealing.

Section 4941 will impose a tax on the amount involved in “self-dealing” between a private foundation and a “disqualified person.” Self-dealing includes the sale, exchange, or leasing of property, the lending of money, the furnishing of goods, services, or facilities, the payment of compensation, or the transfer of the assets or income of the private foundation, or any agreement to make any payment of money or property to a government official (as defined in section 4946(c)). Disqualified persons include Foundation officers, trustees, management-level employees, substantial contributors, and the family members and related entities of such persons. Substantial contributors (as defined in section 507(d)(2) of the Code) are those individuals who donate $5,000 or more if such amount is more than 2% of the total contributions received by the Foundation during its existence. A substantial contributor for one year retains that status in subsequent years. Substantial contributors also include certain family members of any person who is a substantial contributor and any 20% or more owner of a business entity that is a substantial contributor.

(a) Interest-free loans from a disqualified person to a private foundation and the furnishing of goods, services, or facilities to the private foundation without charge generally are exempt, as are the payment of non-excessive compensation by the private foundation and the furnishing of goods, services, or facilities by the private foundation at market rates.

(b) For the disqualified person, initial taxes are 10% of the amount involved; for the private foundation manager (officers, directors, or trustees of the private
foundation or anyone who has similar responsibilities for the private foundation or the specific act of self-dealing), initial taxes are 5% of the amount involved.

(c) Confiscatory punitive taxes of 200% of the amount involved are also imposed on the disqualified person and, in some cases, on the responsible Foundation official at a rate of 50% of the amount involved, if the act of self-dealing is discovered and not corrected.

3. **Section 4942 Tax on Undistributed Income.**

A 30% tax is imposed on private non-operating foundations on "undistributed income" for any taxable year which has not been distributed for exempt purposes before the first day of the second succeeding year. Undistributed income for a taxable year is the minimum investment return (5% of net assets) less expenditures (including administrative costs) incurred for the private foundation's charitable purposes. The 30% tax may be avoided by distributing an amount equal to 5% of the net asset value to charitable purposes prior to the end of the following year. An additional confiscatory tax of 100% is imposed if the undistributed income is not reduced to zero within 90 days after the issuance of a deficiency notice.

4. **Section 4943 Tax on Excess Business Holdings.**

Section 4943 imposes a 10% tax on a private foundation's "excess business holdings." Excess business holdings are a foundation's holdings of a business enterprise which exceed 20% of the voting stock in that enterprise. The 20% threshold is reduced by the percentage of voting stock held by disqualified persons, subject to a 2% de minimus rule. That is, the total percentage ownership of the voting stock of a business enterprise held by the private foundation and its substantial contributors (and their family members) and other disqualified persons cannot exceed 20%, or the excise tax on excess business holdings may come into play.

(a) Substantial contributors to a private foundation are considered disqualified persons. Accordingly, stock owned directly or indirectly by or for a disqualified person through a corporation, partnership, estate or trust is treated as owned proportionately by its shareholders, partners and beneficiaries and is counted as constructively owned by the disqualified person. If the aggregate holdings of the disqualified person and the private foundation exceed 20% of the voting stock of the business as a result of a gift or bequest, the private foundation is required to reduce its holdings to the permitted level within 5 years. This usually requires the divestiture of excess holdings during the five-year period.

(b) The five-year period may be extended for an additional five years in the case of unusually large, illiquid or complex business holdings, provided the private foundation can show diligent efforts to dispose of the excess business holdings within the initial five-year period.

(c) The attribution rules of section 4943 do not attribute stock from one family member to another. While there is generally attribution from an entity, such as a corporation, partnership or trust, to its owners or beneficiaries, there is no attribution in the opposite direction. If the disqualified person has the power to appoint an interest in the business
enterprise to himself pursuant to a presently exercisable power of appointment, then the disqualified person is considered to be the owner of the appointive interest.

(d) A 2% de minimus rule permits a private foundation to hold not more than 2% of the voting stock and not more than 2% in value of all outstanding shares of all classes of stock. For purposes of this rule, however, a foundation's holdings in a business enterprise are lumped together or aggregated with the holdings of other foundations which are "effectively controlled" by the same person or persons, including members of their families.

(e) A confiscatory 200% excise tax is imposed if the excess holdings are not disposed of by the foundation within the prescribed five-year period, plus extensions. The 200% tax is payable upon assessment, unless the excess holdings are disposed of within 90 days of the issuance of a deficiency notice by the Internal Revenue Service.

5. Section 4944 Tax on Investments That Jeopardize Charitable Purpose.

Excise taxes are imposed on a foundation (20%), and in certain cases on responsible foundation officials (10%), if the foundation makes certain investments that jeopardize the carrying out of the foundation's exempt purposes. Such jeopardizing investments are those made without the exercise of ordinary business care and prudence in providing for the foundation's needs in carrying out its exempt purpose, based on all the facts and circumstances at the time of the investment. Although there are no categories of investments that are automatically deemed jeopardizing investments, the following types of investments are "closely scrutinized": margin trading, commodity futures trading, short sales, investment in oil and gas working interests, and the purchase of puts, calls, warrants, and straddle transactions.

6. Section 4945 Tax on Taxable Expenditures.

Taxes on a private foundation (20%), and in certain cases on foundation managers (5%), are imposed if the foundation makes certain "taxable expenditures." Taxable expenditures include payments or amounts incurred to influence the outcome of elections or to influence legislation, grants to organizations that are not public charities (unless certain reporting requirements are met), and grants to individuals for study or travel that are not awarded on an objective and nondiscriminatory basis pursuant to prescribed procedures. Additional taxes will be imposed for taxable expenditures that are not corrected in a timely manner.

B. Unrelated Business Income Tax.

Tax-exempt organizations, including private foundations and charitable remainder trusts, while generally exempt from income tax, are subject to tax on "unrelated business taxable income" or "UBTI."34 Income is subject to the unrelated business income tax ("UBIT") if the income is (i) derived from an activity which constitutes a trade or business, (ii) the trade or business is regularly carried on, and (iii) the activity is not substantially related to the tax-exempt

34 Section 511.
UBTI is subject to UBIT at the regular corporate or trust income tax rate, depending on the form of entity.

Most passive income, including rents, royalties, dividends, interest and annuities, is not subject to UBIT. However, passive income will be subject to UBIT to the extent derived from “debt financed property.” Debt-financed property includes any property held to produce income, including appreciation or gain from the sale of the property, with respect to which there is “acquisition indebtedness” at any time during the year, or during the 12-month period before of the date of the property disposal, if disposed of during the year. Under previous law, UBIT was a significant problem for charitable remainder trusts, because the existence of UBTI resulted in the loss of tax-exempt status. This result was changed by the 2006 Act. For taxable years beginning after 2006, section 664 imposes a 100% excise tax on the unrelated business taxable income of a charitable remainder trust. The tax-exempt status of the charitable remainder trust, however, is not impaired.

As noted above, charitable lead trusts are not tax-exempt, so UBIT is not a consideration.

C. The Prearranged Sale.

If the taxpayer contributes appreciated property to a charity, a private foundation, or a charitable remainder trust with an informal agreement or understanding that the appreciated property will be sold a pre-arranged buyer on pre-arranged terms, and the property is ultimately sold by the charitable organization to that buyer, the Service may take the position that the transaction is a sale by the contributing taxpayer rather than a sale by the tax-exempt organization, under the “anticipatory assignment of income” doctrine. As a result, the gain may be taxable to the contributing taxpayer, as opposed to being a non-taxable sale by the tax-exempt organization. The contributing taxpayer would be required to recognize the full capital gain as income, and then would be treated as making a charitable contribution.

The fact that there may be a pending “global” transaction for the sale of the contributed property or the redemption of stock should not trigger the assignment of income doctrine as long as the donee is not legally bound and cannot be compelled to complete the sale or the redemption.

D. Mortgaged Property.

Contributions of appreciated property encumbered by a mortgage are problematic and raise several issues:

35 Section 512.
36 Section 511(b)(1), (2) and (3).
37 Section 511(b)(4).
38 Section 514(b) and (c).
39 Code Section 664(c), Treas. Reg. §1.664-1(c).
1. **Grantor Trust Status.**

Reg. §1.664-1(a)(4) provides that a charitable remainder trust is not considered created if the grantor or any other person is treated as the owner of the trust. If the grantor is liable on the debt encumbering contributed property, the charitable remainder trust is treated as a grantor trust for income tax purposes. As long as a charitable remainder trust is treated as a grantor trust, it will not be considered a tax-qualified charitable remainder trust. The grantor is not entitled to the income and gift tax charitable deductions and the trust is not entitled to tax-exempt status. Accordingly, the grantor of the grantor trust will be subject to taxation on any capital gain resulting from the sale of appreciated property by the trust.

2. **UBTI.**

As explained above, mortgaged property may result in the application of the debt-financed property rules of section 514 and the generation of UBTI, unless the narrow exception of section 514(c)(2)(B) is available.

3. **Bargain Sale.**

When a charitable remainder trust is funded with mortgaged property, the transaction may be treated as a bargain sale for income tax purposes under section 1011(b). As a result, the grantor will be required to recognize gain on some portion or all of the outstanding mortgage value. This rule applies regardless of whether the mortgage is recourse or nonrecourse, and regardless of whether the grantor continues to pay the mortgage from his own funds.

4. **Self-Dealing.**

A donor would not be eligible to transfer a mortgaged asset to fund a charitable remainder trust if the mortgage was placed on the property within ten years of the transfer. However, the bargain sale of property to a charitable remainder trust or a private foundation is not a direct act of self-dealing, simply because the seller becomes a disqualified person only by reason of his becoming a substantial contributor as a result of the bargain element of the sale. However, if the loan amount remains outstanding once the donor becomes a disqualified person, the IRS has ruled that a new act of self-dealing occurs in each year in which the loan remains uncorrected.

When mortgaged properties are contributed to a charitable lead trust, the transfer will be treated as a sale or exchange for purposes of section 4941 if the charitable lead trust assumes the mortgage, or if the mortgage was placed on the property within ten years of the transfer subject to the mortgage.

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41 Section 4941(d)(2)(A).
42 Reg. §53.4941(d)-1(a).
43 PLR 9530032, revoking PLR 9343033.
44 Treas. Reg. §53.4941(d)-2(a)
E. **S Corporation Issues.**

A number of problems arise when stock of an S corporation is contributed to a tax-exempt organization or a charitable remainder trust. While a section 501(c)(3) organization is a permitted S corporation shareholder, the pro rata share of the S corporation’s income allocable to the tax-exempt shareholder will be subject to UBIT at regular tax rates. On the other hand, a charitable remainder trust is not an eligible S corporation shareholder. As a result, a gift of S corporation stock to a charitable remainder trust will terminate the corporation’s S status.

While a charitable lead trust may elect to be taxed as an ESBT and qualify to hold S stock, this arrangement may produce highly undesirable income tax results, since the ESBT will be taxed on the S corporation income at the highest marginal trust tax rate and the trust will be denied any deduction for the S corporation income distributed to charity.

Prior to the 2006 Act, a shareholder was required to reduce the basis in his or her stock for the amount of any charitable contribution that flowed through to the shareholder as a result of a contribution at the S corporation level. As a result, the shareholder may not have sufficient basis to benefit from a substantial contribution by the corporation of appreciated long term capital gain property to charity. For example, a contribution of property worth $1 million and adjusted basis of $400,000 would result in a pass through deduction of $1 million, but if the shareholder’s outside basis was only $400,000, the deduction for the long term capital gain component would be lost. Section 1203 of the 2006 Act provides that for contributions made in taxable years beginning after 2005 and before 2008, the amount of the shareholder’s basis reduction in the stock of an S corporation by reason of a charitable contribution made by the corporation will be equal to the shareholder’s pro rata share of the adjusted basis of the contributed property. Accordingly, the deduction of the long term gain component would not be disallowed during this period prior to the sunset.

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45 Section 512(c).
46 See Section 1361(c)(2) and (6).
47 Section 641(c)(2)(A), Treas. Reg. §1.641(c)-1(g)(4); Treas. Reg. §1.641(c)-1(l), Example 4.
48 Section 1367(a)(2)(B) (flush sentence).
IV. Case Studies.

A. **Appreciated Real Property to Public Charity or Private Operating Foundation**

- Taxpayer receives charitable deduction for fair market value of appreciated real property ($1,000,000), subject to the 30% AGI limitation.

B. **Qualified Appreciated Property (Publicly Traded Stock) to CRAT**

- Taxpayer receives charitable deduction for the present value of the remainder interest that will pass to the public charity ($330,681 based on $1M fair market value of qualified appreciated stock), subject to the 30% AGI limitation.
  - Remainder must be a minimum of 10%
  - Public charity as remainder organization - 30% of AGI deduction limitation
  - Private foundation as remainder organization - 20% of AGI deduction limitation for gifts of appreciated property (30% for cash gifts)
- Taxpayer age 65 will receive $70,000 per year life annuity
- CLAT immediately sells stock
C. *Appreciated Real Property to CRAT*

- The taxpayer will receive an income tax deduction for the present value of the remainder interest that will pass to the qualified charity ($330,681 based on $1M fair market value of property and life annuity payable to taxpayer age 65)
  - Remainder must be a minimum of 10%
  - Public charity as remainder organization - 30% of AGI deduction limitation
  - Private foundation as remainder organization - 20% of AGI deduction limitation for gifts of appreciated property (30% for cash gifts)
- Taxpayer age 65 will receive $70,000 per year life annuity
- CRAT immediately sells real property
D. Cash Gift to CLAT

- Grantor CLAT - the taxpayer receives an income tax deduction for amount passing to charity
  - $980,288 up-front charitable deduction available to grantor
  - Grantor reports income of CLAT each year

- Non-grantor CLAT - taxed under Subchapter J as complex trust
  - Trust deducts amounts paid to charity each year "to the extent such payments are made pursuant to the terms of the governing instrument"
  - No charitable deduction for non-grantor taxpayer

- Remainder passes to non-charitable beneficiaries at end of term free of gift and estate taxes
E. **Limitations on C Corporation Charitable Deduction**

- Shareholder
  - Basis: $2M

- C Corp.
  - Intangible Assets: $10M
  - Business Assets: $5M
  - Investment Property: $2M (basis - $2k)
  - Taxable income: $3M

- Appreciated Investment Property
  - FMV - $2M
  - Basis - $2k

- Charitable Deduction $2M

- Public Charity

- C corporation charitable deduction limited to $300,000 (10% of taxable income)

- Disallowed deduction carried forward for 10 years

F. **Closely-Held C Corporation Stock to Charity**

- Shareholder
  - Basis: $2M

- C Corp.
  - FMV: $10M

- Public Charity

- Charitable deduction available in the amount of $10,000,000, subject to 30% AGI limitation

- If charity is a non-operating private foundation, the deduction is limited to the taxpayer's basis in the contributed stock ($2,000,000) rather than the fair market value, subject to 20% AGI limitation
G. \textit{S Corporation Stock to Charity}

- Charitable deduction available in the amount of $10,000,000, subject to 30\% AGI limitation.
- If charity is a non-operating private foundation, the deduction is limited to the taxpayer's basis in the contributed stock ($2,000,000) rather than the fair market value, subject to 20\% AGI limitation.

H. \textit{LLC Interests to Charity}

- Charitable deduction available in the amount of $13,000,000, subject to 30\% AGI limitation.
- If charity is a non-operating private foundation, the deduction is limited to the taxpayer's basis in the contributed LLC interests ($2,000,000) rather than the fair market value, subject to the 20\% AGI limitation.
I. *S Corporation Contributes Appreciated Property to Charity*

- The appreciated property contributed by S Corp has section 1374 BIG of $600,000. The charitable organization immediately sells the property for $1,000,000.
- The charitable deduction of $1,000,000 is passed through to the S corporation shareholders, subject to the basis limitation and the 20% or 30% AGI limitation, depending on the charitable donee’s exemption status, determined at the shareholder level.
J. *S Corporation CRUT*

The appreciated property contributed by S Corp has section 1374 gain of $500,000. The CRUT immediately sells the property for $1,000,000.

- PLR 200644013 held that:
  - No built-in gain is recognized on the contribution of the real estate to the CRUT, or upon the sale of the property by the CRUT
  - The S Corp will not have recognized built-in gain on the unitrust amounts received by it during the recognition period (through 2014) or thereafter

- The charitable deduction for the charitable remainder interest ($201,171) is passed through to the S corporation shareholders, subject to the basis limitation and the 20% or 30% AGI limitation determined at the shareholder level