

Professional Notes

SUMMER 2017

TAX & ESTATE PLANNING

Charitable Gifts of Closely Held Business Interests and Other Illiquid Investments

Many donors hold a significant part of their wealth in illiquid securities, such as interests in closely held businesses and restricted stock of corporations, or alternative investments, such as hedge funds and private equity funds. Closely held businesses and alternate investments may be organized as corporations, or they may be limited partnerships or limited liability companies (LLCs) that are taxed as pass-through entities, with each partner or member taxed on his or her share of net income or gain. The entity's form affects the tax consequences of a charitable gift of an equity interest.

This edition of *Professional Notes* provides a broad overview of the issues involved when a donor wants to fund a charitable gift with interests in closely held businesses and other illiquid investments. In the section on hedge funds and private equity partnerships, we highlight a unique charitable giving opportunity available in 2017 for hedge fund managers who have deferred some of their compensation through the use of offshore vehicles.

General Considerations

A donor's income tax treatment for a charitable gift of illiquid securities depends on three things: the type of security contributed, the donor's holding period for the security, and the type of charity to which it is contributed.

Written by Jane L. Wilton, General Counsel of The New York Community Trust, with special thanks to Patterson Belknap Webb & Tyler LLP for its assistance.

The material is published for informational purposes only. The publisher is not rendering legal, accounting, or other professional advice.

2017 SERIES

Spring
Charitable Gifts of
Publicly Traded Securities

Summer
Charitable Gifts of Closely Held
Business Interests and Other
Illiquid Investments

Fall
Timing of Charitable
Contributions

Professional

A charitable gift of an interest in a closely held business requires careful planning.

Generally, the income tax charitable deduction for a contribution of securities is the fair market value of the securities reduced by the amount of gain that would *not* have been long-term capital gain if the securities had been sold at fair market value. As a result, when a donor contributes securities held for more than one year (i.e., long-term capital gain property) to a public charity, he or she can claim an income tax charitable deduction for the contribution based on its fair market value—and avoid the taxable capital gain from the appreciation.

For a contribution of an interest in a partnership with no liabilities, the fair market value deduction will be reduced to the extent the partnership owns ordinary income assets. The portion of the gift attributable to the partnership's ordinary income assets will be deductible only to the extent of the partnership's basis in those assets. The IRS has ruled that when a taxpayer transfers a partnership interest, the taxpayer's share of partnership liabilities constitutes an "amount realized" by the donor, causing the donor to be treated as engaging in a "bargain sale."

By contrast, only a gift of securities that meet the definition of "qualified appreciated stock" qualifies for a fair market value deduction when contributed to a private non-operating foundation. Qualified appreciated stock is defined as stock in a corporation for which market quotations are readily available on an established securities market and that is a long-term capital asset. This rule for private foundations has limited and comparatively rare exceptions (e.g., a gift to a "pass-through" foundation that distributes the gift within a specified time).

Even if the stock is qualified appreciated stock, if the total amount of stock contributed, including all past contributions, exceeds 10 percent of the value of all outstanding stock of the corporation, the donated stock in excess of this threshold will not be considered qualified

appreciated stock. Therefore, a donor's deduction for giving restricted or closely held stock, or interests in most partnerships and LLCs, to a private, non-operating foundation ordinarily will be limited to the donor's basis.

The Internal Revenue Code (Code) generally permits a charitable deduction of up to 30 percent of an individual donor's adjusted gross income for gifts of long-term capital gain property contributed to a public charity or private operating foundation. But a gift of such stock to a private non-operating foundation is ordinarily deductible only up to 20 percent of adjusted gross income. Any unused deductions may be carried forward for up to five more tax years.

Interests in a Closely Held Business

A charitable gift of an interest in a closely held business requires careful planning. A key concern for the owners of the business may be the impact of adding an outsider as an owner. In addition, charitable organizations typically do not want to hold illiquid investment assets, particularly interests in an operating business (as distinct from, say, a private equity fund or a hedge fund). To address these concerns, a redemption of the charity's interest at fair market value soon after the gift is completed may be appealing to both the charity and other owners of the business.

To avoid triggering the inherent capital gain, however, the contribution and subsequent redemption must occur without prearrangement between the donor and the charity. That is, there must be no pre-existing obligation that the charity will tender its donated interest or that the business will redeem the charity's interest. Under the "assignment of income doctrine," a gift that is linked to a prearranged redemption could be reclassified for tax purposes as a sale by the donor (with corresponding realization of the gain), followed by a gift to charity of the proceeds.

Notes

If the charitable recipient is a private foundation or a donor-advised fund, the application of the excess business holdings rules must also be considered. These rules are not triggered so long as a private foundation or donor-advised fund owns 2 percent or less of the donated business (both as a percentage of vote and a percentage of value), but the excess business holdings rules become an important consideration once the charity's stake exceeds either of those levels.

Generally speaking, there will be excess business holdings (and hefty excise taxes may apply) if the combined holdings of the private foundation or donor-advised fund and its "disqualified persons" (e.g., the donor, his or her spouse, and their children or trusts for their benefit) is more than 20 percent of the voting or non-voting stock of a corporation or more than 20 percent of the profits or capital interest in an LLC or partnership. However, the permissible threshold increases to 35 percent if the foundation or donor-advised fund can demonstrate that the business is effectively controlled by third parties who are not disqualified persons. Any interest in a sole proprietorship will be excess business holdings for a private foundation or a donor-advised fund.

In the case of gifts and bequests, there is a five-year "grace period" to bring holdings within permitted levels, and, in special cases, the IRS may exercise its discretion to grant one or more extensions. It will be important to identify this issue before the gift is made, so there can be a plan in place (e.g., the possibility of redemptions or sales to unrelated third parties) to bring holdings within permitted levels.

Newman's Own Foundation—established by actor Paul Newman, who died in 2008—is seeking repeal of these rules so the Foundation can continue to own 100 percent of the well-known food company that Newman bequeathed to the Foundation. Right now, the Foundation is nearing the end of its second five-year holding period.

Note that the excess business holdings rules apply only if the business is a "business enterprise." Therefore, interests in a "functionally related business" (i.e., related to the tax-exempt purpose of the charity) or one that derives at least 95 percent of its gross income from passive sources are not subject to the excess business holdings rules.

S Corporation Stock

Some closely held businesses are structured as Subchapter S corporations. They generally operate as corporations, but are treated similarly to partnerships for tax purposes (i.e., with flow-through treatment of their income and no tax at the entity level). By definition, Subchapter S corporations may not have more than 100 shareholders.

In evaluating a potential gift of Subchapter S stock to charity, a donor should be aware of the types of assets held by the corporation, especially appreciated inventory or unrealized receivables. A fair market value charitable deduction for the gift of appreciated stock must be reduced by the amount of "ordinary income" the donor would have recognized if he or she had sold the property. Code Section 170(e)(1) provides that "rules similar to the rules of [Code] section 751 shall apply in determining whether gain on [S corporation] stock would have been long-term capital gain if such stock were sold by the taxpayer." Consequently, the donor's deduction for a contribution of Subchapter S stock, in most instances, will not be the full fair market value of the stock, but will be reduced to the extent of the donor's share of the corporation's appreciated inventory and unrealized receivables, including depreciation recapture.

Charities usually are reluctant to accept gifts of Subchapter S stock because all items of income and gain allocable to the charity during the period it holds the stock (including the gain on disposition of the shares) will constitute unrelated business taxable income (UBTI) and will be taxable in its

As a general rule, a donor who contributes a partnership interest or units of an LLC with no liabilities to a public charity or private operating foundation receives a tax deduction equal to the fair market value of the property, provided the donor has held it for more than a year.

hands. These rules generally are less favorable than the rules for gifts of partnership interest, discussed below. A donor of Subchapter S stock should expect the charitable donee to want assurances there will be adequate distributions from the corporation to cover the charity's potential tax liability.

One alternative may be for the Subchapter S corporation itself to donate assets to charity. The gift is treated as if made on a pro rata basis by the shareholders and is subject to their individual contribution limits. Generally, the shareholder's basis in his or her shares is reduced pro rata by the shareholder's share of the corporation's basis in the property contributed to charity, and the charitable deduction available to the shareholder for gifts by the corporation is limited to the basis in his or her shares.

Restricted Stock

Stock—whether or not closely held—may be subject to restrictions on sale imposed by law, by agreement with an underwriter, or by a shareholders' or other agreement. Restricted securities generally trade at a discount relative to freely traded shares.

The contribution of restricted stock to charity raises issues about the amount a donor may claim as an income tax charitable deduction. Long-term capital gain assets, including securities, may be deducted at fair market value when donated to public charities (and private operating foundations), even if the shares are not considered readily marketable. This includes gifts to a public charity for a donor-advised fund.

However, as previously noted, it is usually the case that only "qualified appreciated stock" contributions to private non-operating foundations are deductible at fair market value. The IRS has ruled privately that stock subject to Rule 144 (i.e., restricted stock of a type that is publicly traded, but is not readily marketable under SEC rules) is not "qualified appreciated stock." Moreover, the IRS

noted that the value of the stock was discounted from the value of the unrestricted shares listed on the established securities market because of the resale restrictions.

In a Private Letter Ruling involving a contribution to a private non-operating foundation of stock subject to Rule 144 volume restrictions, where the donor agreed to restrict his own sales so the volume restriction would not prevent the foundation from selling the shares, the IRS held that the stock *was* qualified appreciated stock, deductible at fair market value, because the shares the foundation received would be freely transferable upon receipt.

Pass-Through Entities

Gifts of interests in pass-through entities, such as partnerships and LLCs, present novel tax issues for the charity and the donor, and require careful consideration.

As a general rule, a donor who contributes a partnership interest or units of an LLC with no liabilities to a public charity or private operating foundation receives a tax deduction equal to the fair market value of the property, provided the donor has held it for more than a year. However, there is an important limitation to the extent the partnership owns ordinary income assets, such as unrealized receivables or inventory. Those assets—sometimes called Code Section 751 assets, or "hot assets"—may be included in the donor's deduction only to the extent of the donor's basis in the partnership, as if the donor had given a pro rata share of his or her interest in the partnership's underlying assets.

The New York Community Trust, like most charities, will not accept a *general* partnership interest; the for-profit activity generally is inconsistent with our charitable mission and places charitable assets at risk for the liabilities of the partnership. Even if the donated asset is a limited

Notes

partnership interest or an interest in an LLC, most charities will want assurance they will not be subject to capital calls under the governing documents.

A charity may be reluctant to accept gifts of partnership interests because income and gain will be allocable to the charity during the time it holds the interest. It will need to understand the underlying business of the partnership, and whether the partnership uses debt, to determine whether all or part of its allocable income and gain from the partnership may constitute unrelated business taxable income. A charity is unlikely to accept an interest in a partnership that will produce UBTI unless it can be certain the distributions will cover its potential tax liability, and even then, it may have reservations about the receipt of UBTI (e.g., the burden and possibly enhanced audit risk associated with starting to file IRS Form 990-T).

Before accepting a gift of a partnership interest, particularly an interest in a partnership structure with multiple layers, a charity likely will want to be sure the partnership is properly reporting all “reportable transactions” (transactions that must be specifically disclosed to the IRS). Failure to include information about a reportable transaction can result in significant tax penalties. Indeed, the charity may want representations from the partnership that it is not engaged in any reportable transactions or listed tax shelter transactions.

As discussed above in connection with Subchapter S corporations, a partnership can donate assets to charity directly, passing through the deduction to its partners subject to certain limitations.

No partial interests. Under the partial interest rules generally applicable to gifts of property, the donor of a partnership interest must give charity his or her entire interest or an undivided portion of that entire interest. Otherwise, no deduction will be allowed. An undivided portion of a donor’s partnership interest must be expressed as a fraction

or percentage, so it includes a pro rata share of each and every attribute of the interest, such as capital, allocation of income and expense, and distributions.

Gift subject to liabilities. As with any charitable gift of property, a gift of a partnership interest subject to liabilities may be treated as a bargain sale, resulting in the donor’s recognition of taxable gain. The donor will be deemed to have sold his or her partnership interest to the extent of his or her allocable share of liabilities; his or her basis in the partnership will be allocated pro rata between the amount treated as sold and the amount treated as a charitable contribution.

Passive activity losses. Losses that arise from activities in which a partner did not materially participate (including most limited partner interests) may be claimed as losses by a partner only to the extent of income or gain from those activities or upon a qualifying disposition of the passive activity. A charitable contribution of a partnership interest is not a qualifying disposition for these purposes, and a donor will not be able to take a deduction for suspended passive activity losses.

An individual with suspended passive activity losses from a partnership should consider whether he or she would be better off selling the partnership interest, deducting the losses, and donating the net proceeds to charity.

Hedge Funds and Private Equity Partnerships. A partner with a carried interest in a partnership may want to consider contributing all or an undivided portion of the interest to charity. A carried interest is an interest in the partnership, typically without any capital contribution. Under current law, the carried interest is treated as a capital asset and, as such, is subject to favorable capital gains tax rates upon sale or other disposition; a charitable contribution of such an interest would be subject to the rules generally applicable to partnership interests.

A partner with carried interest in a partnership may want to consider contributing all or an undivided portion of the interest to charity.

Because hedge funds often raise money through borrowing, they are likely to produce UBTI as a result of the application of the debt-financed income rules. To enable charities to invest in alternate investments such as hedge funds without incurring significant tax liabilities, U.S. hedge funds commonly create foreign feeder funds called “blocker corporations”. The dividends charities receive from foreign blocker corporations are not considered debt-financed income and therefore are not UBTI.

Unfortunately, if a donor contributed his or her interest in the U.S. feeder fund to a non-U.S. blocker corporation, the donor could recognize gain under Code Section 367. If, instead, the donor gave the interest to charity and charity then contributed the interest to a non-U.S. blocker corporation, charity likely would be treated as recognizing the gain—which would be taxable to charity as UBTI (i.e., debt-financed income).

Hedge fund managers may have greater motivation to make charitable gifts in 2017 if, prior to 2009, they structured management compensation using deferred arrangements, investing that deferred compensation in offshore funds. Under Code Section 457A, this deferred compensation must be recognized in 2017; charitable gifts may offer an opportunity to offset some of the resulting taxes.

Valuation and Appraisal Requirements

The fair market value of a contributed asset is determined as of the date of gift, usually by reference to recent arm’s length sales.

Unfortunately, this information is rarely available for closely held or restricted stock or for other non-publicly traded business interests, such as LLC and partnership interests.

Except for contributions of publicly traded securities, the IRS generally requires an appraisal

by a qualified appraiser of contributed property valued at more than \$5,000. However, for non-publicly traded stock, an appraisal is not required unless the stock is valued at more than \$10,000. Failure to obtain an appraisal when it is required will result in the disallowance of any deduction for the gift. If the deduction is more than \$500,000, the qualified appraisal must be filed by the donor with the IRS.

Among other requirements, a qualified appraiser is someone who has met certain minimum education and experience requirements and who regularly prepares appraisals for pay. No part of the fee arrangement can be based on a percentage of the appraised value of the property. By definition, the donor and the recipient charity are not qualified appraisers.

An appraisal is not a qualified appraisal if it was made more than 60 days before the date of contribution or after the due date (with extensions) of the return on which the deduction must be claimed.

Conclusion

Illiquid securities, such as interests in closely held businesses and restricted stock of corporations, or alternative investments, such as hedge funds and private equity funds, can be smart choices for charitable gifts. However, donors and charities must consider a number of issues when making and accepting such gifts. Among the concerns are the timing and valuation of the gift, potential tax liabilities, and the ability of charity to subsequently dispose of the contributed asset. The New York Community Trust is experienced in handling these gifts. If your client is considering contributing such interests, The Trust can provide opportunities for integrating long-term philanthropic goals into a donor’s business planning, while generating a significant tax deduction.

Failure to obtain an appraisal when it is required will result in the disallowance of any deduction for the gift.

Notes

For further information, see

IRC §170(b)(1)(A): General rule for percentage limitations for individuals

IRC §170(e)(5): Qualified appreciated stock

IRC §170(f)(3)(A): Denial of deduction for certain contributions of partial interests in property

IRC §170(f)(11): Qualified appraisals

IRC §457A: Nonqualified deferred compensation

IRC §469: Passive activity losses.

IRC §§512 - 514: UBIT rules

IRC §751: Partnership unrealized receivables and inventory

IRC §752: Treatment of certain partnership liabilities

IRC §6111: Disclosure of reportable transactions

IRS Form 8283 (Noncash Charitable Contributions)

Treas. Reg. §170A-13(c)(3): Qualified appraisals

Rev. Rul. 75-194, 1975-1 CB 80 (charitable contribution of partnership interest subject to liabilities treated as deemed sale to the extent liabilities exceed the donor's basis)

Rev. Rul. 96-11 (partnership charitable contribution of property)

PLR 9247018: Rule 144 stock ruled not "qualified appreciated stock"

PLR 9734034: Rule 144 stock "qualified appreciated stock" where volume restrictions would not apply due to donor agreement not to sell shares

Paul Newman's Foundation Fights Looming 200 Percent Tax, *The Daily Tax Report* (August 17, 2016)

If you think a colleague would like to receive complimentary copies of *Professional Notes*, or if you'd like past issues, e-mail us at aja@nyct-cfi.org. For a list of past issues of *Professional Notes*, published by The New York Community Trust, see nycommunitytrust.org.



2016 SERIES

Charitable Giving Update: Topics of Note in 2016 (Spring)

Estate Planning for the Non-Taxable Estate (Summer)

Gifts in Jeopardy: What Happens When a Charity Goes Broke (Fall)

2015 SERIES

Changing Course: Early Termination of Charitable Remainder Trusts (Spring)

Early Termination of Charitable Lead Trusts (Summer)

Changing a Private Foundation's Status (Fall)

Terminating a Private Foundation (Winter)

2014 SERIES

From Self-Regulation to Government Regulation (March)

IRS Efforts to Improve Nonprofit Governance (June)

New York Revitalizes: State Governance Reform for Nonprofits (October)



“I’m here
to help you
help your
clients.”

Are your clients doing estate planning?
Are they making charitable decisions now?
Selling a business? Managing an inheritance?

The Trust can help.

For nearly 100 years, we’ve worked with nonprofits, donors, and attorneys in New York. Our grants bolster the arts, protect the environment, feed the hungry, educate children, and more. Because The New York Community Trust is a public charity, donors are ensured the maximum deduction allowed by law.

Contact me.

Jane Wilton, general counsel

(212) 686-2563

janewilton@nyct-cfi.org



909 Third Avenue, 22nd Floor
New York, NY 10022
(212) 686-0010
nycommunitytrust.org



900 Walt Whitman Road, Ste. 205
Melville, NY 11747
(631) 991-8800
licf.org



210 North Central Avenue, Ste. 310
Hartsdale, NY 10530
(914) 948-5166
wcf-ny.org

The Trust: Here for New York. Here for Your Clients. Here for You.