

Charitable Gift Strategies for the Owner of a Closely-Held Business

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CHARITABLE GIFT STRATEGIES FOR THE OWNER OF A CLOSELY HELD BUSINESS

I. Closely-Held Business Owners and Philanthropy

Owners of closely-held businesses represent a significant percentage of our countrys most philanthropic individuals. They tend to be appreciative of their good fortune and many want to give back to the communities that have nurtured their companies. More and more, the philanthropically-minded business owner is also interested in finding ways to involve his/her family in charitable giving and using philanthropy to pass on family values. Because our tax system accords special benefits to those who give, business owners also have a unique opportunity to achieve other financial, personal or business goals through charitable giving.

Addressing the business owners philanthropic goals as part of his/her overall planning is an important element of any comprehensive plan. Advisors to the business owner should develop a comfort level with guiding the business owner through a discussion of the importance of philanthropy to the business and to the family. Community foundation staff or other philanthropic advisors can be asked to join the advisor team to determine how best to meet the familys philanthropic goals within an overall business strategy or as part of succession or estate planning.

According to a recent study conducted by The Philanthropic Initiative (TPI) which interviewed more than 500 high-net-worth individuals and families, these families are eager for advice and guidance on how to make their giving more meaningful and strategic. In overwhelming numbers the donors interviewed reported that it was they and not their advisors who typically raised the subject of philanthropy. These donors trusted their advisors for their technical expertise but wanted their advisors to take a more comprehensive approach to their giving. And, if their advisors were not knowledgeable about philanthropic giving, donors wanted to be connected to those who could be of service.

The TPI study also found that family philanthropy was often an excellent tool as the new family enterprise replacing a family business that was sold. Family philanthropy, the study goes on to say:

- Provides elevated ground for families to work together.
- Offers the opportunity for several generations to join in a common purpose.
- May become the glue that binds families whose branches are increasingly geographically diverse.

The successful business owner is seeking financial security but is also seeking an opportunity to find additional meaning in his/her life and for the family. Philanthropy plays this part in his/her life.

II. Introduction

In today's economy, an individual donor may find that the best source of funds with which to make charitable contributions are those held in his or her closely held business. The owner of a closely held business has a number of alternatives available to him in accessing such assets for use in making charitable gifts. Such assets may include cash, other assets held by the corporation, or an ownership interest in the business. This outline summarizes a number of strategies to achieve various charitable goals of the business owner: (i) to maximize the tax benefits of a charitable contribution; (ii) to select the appropriate asset of the closely held business to be contributed; (iii) to possibly structure the gift so as to supplement the cash flow available to the business owner; (iv) to involve his family members in management of the charitable gift; and (v) where possible to coordinate with the owner's succession planning for the business.

III. Typical Fact Situation

There are three basic alternatives for the organization of a business entity: (i) a C corporation which pays income taxes on its taxable income; (ii) an S corporation, the taxable income and certain expenses of which typically flow through to the shareholders; and (iii) a partnership, the income and expenses of which flow through to the partners. Limited liability companies are a fourth alternative, but because they are taxed as partnerships, they will not separately be discussed here. As most closely held businesses are either S corporations or partnerships, this outline will focus primarily on such entities.

It is assumed that the business has either cash or an appreciated asset which is suitable for a gift to a charity. Alternatively, it is assumed that the business owner could make a gift of stock in his C or S corporation, or an interest in his partnership. The business owner should first determine whether there are any restrictions imposed on the transfer of an interest in the business through a shareholder's agreement, a buy-sell agreement with other owners or under the partnership agreement. Furthermore, there may be restrictions imposed under loan or other agreements with creditors which may prohibit the transfer of an interest in the business. Finally, securities laws impose restrictions on transfer of some publicly traded stock.

IV. Typical Charitable Donees

A. Direct Gifts to Public Charities

Giving directly to a publicly supported organization is the most common and familiar form of charitable giving and is the lifeblood of the nation's nonprofit sector. For donors with the capability to make substantial gifts or gifts of permanent endowment, however, direct contributions to individual charities may not always be the most appropriate form of giving. Once a major gift has been made, the donor has very limited control over the continued use of the gift and may lose recognition for the gift after it is commingled with others. In addition, most individuals support more than one charity, but making and keeping track of tax-effective gifts to numerous organizations (through gifts of appreciated property, for example) can be cumbersome. Similarly, many individuals have a desire broadly to give back to the

community, or a deep interest in a broad charitable cause rather than an attachment to a particular organization. Finally, an organization that is serving the interests of the donor today may change its mission or cease to exist ten years from now.

B. Establishing a Private Foundation

Our state and nation have been immeasurably enhanced over time through the grants of hundreds of private and family foundations. A private foundation is an independent charity established, controlled and maintained over time by the donor under the direction of the board of directors which may include the donor. Private foundations offer substantial flexibility: they can be established for virtually any charitable purpose. For donors in the right circumstance, the private foundation is a very satisfying vehicle for charitable giving.

For some donors, however, the private foundation option carries significant drawbacks. First, the tax benefits of some gifts to private foundations are more limited than those of gifts to public charities. For example, donors can only deduct the cost basis of gifts of closely-held stock to a private foundation whereas they can deduct the fair market value to a public charity. The foundations trustees must comply with stringent IRS regulations. Private foundation tax returns are public information, affording the donor limited privacy in the operation of the foundation. And the administrative burdens of maintaining a private foundation over time may be formidable and costly. Because of these various limitations, a private foundation often is not a practical option unless the donor is prepared to make a substantial commitment of time and/or money.

C. Establishing a Fund at a Community Foundation

Creating a fund at a community foundation combines the tax advantages of a gift to a public charity with the individualization of a private foundation. Funds at a community foundation, and in particular donor advised funds, represent one of the fastest growing segments of charitable giving in the country. Through a community foundation the donor can create a personal philanthropic fund for virtually any charitable purpose and maximize the tax benefits. The staff of the community foundation essentially become the donors staff helping the donor achieve the full expression of his/her philanthropic values and goals. Flexibility is the hallmark of community foundations. The donor can address the changing needs of the community over time (unrestricted fund) or support a broad charitable cause such as the arts or the elimination of poverty (field of interest fund). The donor can name a particular charity whose work he/she wishes to support (designated fund), or the donor can continue to advise the community foundation of his/her charitable interests as they may change over time (donor-advised fund).

Community foundations can accept the full range of gifts including deferred gifts. More and more community foundations are being used by donors as a way to involve the entire family in learning more about charitable giving.

The enclosed chart at Exhibit One compares a fund at a community foundation with a private

foundation.

V. Review of Charitable Income Tax Deduction Rules

A. Reporting Charitable Income Tax Deductions

1. Charitable gifts by a C corporation are reported and deducted on its federal income tax return, Form 1120.

2. An S corporation may not claim a deduction for its charitable contribution and such contributions are excluded from the calculation of the S corporations taxable income. (IRC Section 1363(b)(2)). Instead, such contributions pass through as separate items to the shareholders. The shareholders are then subject to their own limitations on taking such deductions on their individual income tax returns, as described below.

3. Charitable contributions by partnerships are excluded from the computation of partnership income or loss (IRC Section 703(a)(2)(C)) Instead, such amounts are taken into account separately by the partners on their individual income tax returns, and they are then subject to their own limitations on the deductions. (IRC Section 702(a)(4)).

4. The above taxpayers must comply with the requirements of Treas. Reg. Section 1.170A-13 for record keeping and return filing.

B. Limitations on Deductions at the Entity Level

1. A C corporation may deduct the value of charitable contributions received during the tax year up to a limit of 10% of its adjusted taxable income. (IRC Section 170(b)(2)). The 10% flat rate does not vary with the type of contribution or the donee.

2. As indicated above, charitable contributions by S corporations flow through to the shareholders. Under IRC Section 1366(d)(1), the aggregate amount of losses allocated to an S corporation shareholder and other deductions, such as charitable contributions, may not exceed the sum of the shareholders tax basis in his S corporation stock, plus the amount of loans, if any, made by the shareholder to the S corporation. Any portion of a deduction not usable due to this limitation can be treated as incurred by the s corporation in the succeeding tax year with regard to that shareholder. (IRC Section 1366(d)(2)). The S corporation shareholder then reduces his basis in his stock by the full amount of the deduction allocated to him. (IRC Section 1367(a)(2)(B)).

3. As indicated above, charitable contributions by partnerships are not deductible in computing partnership taxable income (IRC Section 703(a)(2)(C)) Such items are taken into account separately by the partners. (IRC Section 702(a)(4)) Unlike the case of S corporations in which the sum of both losses and separate deductions allocated to a shareholder cannot exceed the sum of his basis in his stock and loans made to the corporation by the shareholder, partnership limitations on deductions are broader. A

partners tax basis includes his share of all partnership debt (not just that debt loaned by the partner). Thus, his capacity to deduct partnership losses allocated to him is typically greater. Moreover, the limit of the partners basis only applies to his share of losses; the separately stated deductions, such as charitable deductions, may be taken even if in excess of this limit. Thus, a partner could deduct a charitable contribution of the partnership even if such charitable contribution exceeds the tax basis of the partners interest in the partnership. (Treas. Reg. Section 1.704-1(d)(2). [List of types of losses covered by Section 704(d) not including charitable deductions.] Also see PLR 8405084, Section 704(d) not applicable to partnerships charitable deductions.) The partners basis in the partnership interest is reduced by the basis of the contributed property, not by its fair market value. (Rev. Rul. 96-11, 1996-4 CB 28) This rule may make partnerships more attractive as a vehicle for charitable gifts.

C. Limitations on Deductions at the Individual Level

In the cases of charitable contributions allocated to an individual shareholder of an S corporation or an individual partner of a partnership, in addition to the entity level limitations on deductions described above, the Internal Revenue Code imposes additional limitations on taking such deductions in any particular tax year. The deductions for an individuals charitable contribution is limited to prescribed percentages of his contribution base which is the individuals adjusted gross income without any deduction for net operating loss carrybacks (IRC Section 170(b)(1)(F)).

1. 50% Ceiling Under IRC Section 170(b)(1), an individual may take a deduction up to 50% of his contribution base to what are called 50% charities which include churches, community foundations, educational organizations, foundations for the benefit of colleges, hospitals and other publicly supported organizations; the 50% ceiling only applies to contributions of cash. If the charitable contribution is in the form of property which if sold would result in a long term capital gain, the deduction for that item may not exceed 30% of the individuals contribution base. (IRC Section 170(b)(1)(C)(i)).

2. 30% and 20% Ceilings If the charitable donee is not a 50% charity, the deduction is limited to 30% of the contribution base. Typically, such 30% charities are private foundations. When the asset contributed to the 30% charity is long-term capital gain property, the deduction is limited to 20% of the individuals contribution base. (IRC Section 170(b)(1)(D)(i) ordering rules apply for deducting charitable contributions in more than one percentage limitation category.

3. Carryover of Excess Charitable Contribution Deductions

When an individuals charitable contributions for a year exceed the 50%, 30% or 20% limit, the excess may be carried forward and treated as made in the five succeeding tax years. Amounts carried over are subject to the same percentage limits in the year to which they are carried (IRC Section 170(d)(1)(A)).

D. Computing the Amount of the Charitable Contribution The amount deductible for a charitable contribution of property other than money is the fair market value of the property at the time of contribution. However, the Internal Revenue Code requires that adjustments be made in the value of

certain types of properties contributed.

1. Deductions for Contribution of Property that has Declined in Value Where the property's fair market value is less than its tax basis, the deduction is limited to the lower fair market value. (Rev. Rul. 79-419, 1979-2 CB 107).

2. Deductions for Contributions of Appreciated Property

Where the property to be contributed, if sold would produce either ordinary income or short term capital gains, the contribution amount must be reduced by the amount of such ordinary income or short term capital gain. (IRC Section 170(e)(1)(A)). This rule typically applies to a contribution of inventory or depreciable property used in a trade or business which is subject to depreciation recapture. It could also apply to a contribution of publicly traded stock or real estate if held at the time of the contribution for less than a year. With regard to a contribution of undeveloped real estate, if such real estate is treated as held for sale to customers (inventory type), which would produce ordinary income as opposed to long term capital gains if sold, then the amount of the contribution must be reduced by the amount of such ordinary income. Stock or other capital investments held for more than 12 months if donated to a 50% charity, may be deducted at their fair market value. However, the deduction for a contribution of appreciated long-term capital gain property to a private foundation must be reduced by 100% of the long-term capital gain which would have been recognized had the property been sold. (IRC Section 170(e)(1)(B)). This capital gain reduction does not apply to contributions of qualified appreciated stock under Section 170(e)(5). Qualified appreciated stock is publicly traded stock held as a capital asset.

3. Liabilities Transferred as Part of the Charitable Contribution

If, in connection with a charitable contribution, a liability is assumed by the charity, or if the property is taken by the charity subject to a liability, the amount of the contribution must be reduced by the amount of the liability. (Treas. Reg. Section 1.170A-3(d), Ex. 1). In addition to this reduction in the amount of the charitable contribution, the transaction is bifurcated into a part-gift, part-sale. (TC Memo 1983-200, 45 CCH TCM 1283). The amount of the liability is treated as amount realized by the donor and to calculate gain or loss on the sale, he must apportion his tax basis in the property contributed between the sale and gift portions. The basis is allocated to the sale based upon the ratio of the amount of debt to the fair market value of the property. The liability assumed or taken subject to is then compared to the basis to determine if gain or loss is realized.

EXAMPLE: Assume that undeveloped real estate with a value of \$100,000 subject to a debt of \$25,000 is contributed to charity. Further assume that the donor's basis in the property is \$60,000. The transaction is treated as a part-gift, part-sale and the amount of the debt, \$25,000, is treated as being realized on the sale. The portion of the basis allocated to the sale is determined by the ratio if $25,000/100,000$ or 25%. Thus, 25% of \$60,000, or \$15,000 is the basis of the sale, resulting in gain

realized by the donor of \$10,000. The amount of the charitable deduction is \$75,000.

4. Special Rules for Gifts of S Corporation Stock or Partnership Interests to Charity

a. Appraisals In order to avoid potential application of substantial understatement of tax penalties in charitable gifts of S corporation stock or partnership interests, an appraisal of the value of the interest or stock should be obtained and attached to the income tax return. Note that if the interest or stock is a minority interest, then it is likely discounts will apply to the valuation, thereby reducing the amount of the charitable deduction. Discounts due to lack of a market may also apply. Finally, care should be taken to determine whether the transfer of such interests or stock is prohibited by any agreement with other owners, with creditors or under securities laws.

b. Partnership Interests If the partnership has liabilities, then the IRS considers the transaction to be a part-gift, part-sale as described above. This means that the amount of the charitable deduction must be reduced by the share of debt allocable to the interest given to charity. The amount of the liability shifted under IRC Section 752 to the charity would be considered as an amount realized on the sale. In addition, the partner is deemed to have sold that portion of the interest represented by the ratio of the debt divided by the fair market value of the interest. His basis would be allocated to the sale portion as described in the above example. Thus, gain could be realized upon such a gift. (see Rev. Rul. 75-194, 1975-1 CB 80).

Even if the partnership has no liabilities, the amount of the charitable contribution of the partnership interest must be reduced by the amount of ordinary income or short term capital gains that would be realized by the partner if instead of contributing the interest, he sold it. (IRC Section 170(e)(1)).

c. S Corporation Stock Unlike the situation of a charitable gift of a partnership interest, a charitable gift of S corporation stock where the corporation has liabilities does not result in a reduction of the amount of the contribution or treatment as a part-gift, part-sale. However, the same rules described above for partnerships also apply in valuing the S corporation stock. If the corporation sold its assets and allocated ordinary income or short term capital gains to the shareholder, then the value of the gift of stock must be reduced by that amount of ordinary income and short term capital gain that would be allocated to those shares being transferred. (IRC Section 170(e)(1)).

d. Tax Effects of Gifts of S Corporation Stock to Charity Tax-exempt organizations are now allowed to hold shares in S corporations, except for charitable remainder trusts. However, there could be adverse tax consequences to the charity by becoming a shareholder of an S corporation. Tax-exempt entities are subject to federal income tax on what is called unrelated business taxable income which can arise from receiving income from an activity unrelated to the exempt purpose of the charity. (IRC Section 512). Such income may also arise from debt-financed income, such as income from assets subject to a pre-existing debt. (IRC Section 514). In either case, the income, if it is unrelated business taxable income, can cause the charity to incur federal (and possibly state) income taxes.

In the case of holding S corporation stock, all pass-through income allocated to the charity by the S

corporation will be considered to be unrelated business taxable income (IRC Section 512(e)(1)(B)(i)). Also all gain on the sale by the charity of the S corporation stock will be unrelated business taxable income. (IRC Section 512(e)(1)(B)(ii)). It is not uncommon for donors of S corporation stock to make additional contributions to the charity to reimburse it for such taxes.

e. Tax Effect of Gift of Partnership Interest to Charity Unlike the case of an S corporation, not all income allocated to a charity is a partner in a partnership will be unrelated business taxable income. That portion which is passive income will not be categorized as such. This rule may make partnerships a more attractive vehicle for charitable gifts.

5. Contributions to Charitable Remainder Trusts a. General Charitable remainder trusts are split-interest trusts in that they benefit one or more non-charitable beneficiaries for a period of time, followed by the remainder being distributed to one or more charities. (See IRC Section 664). Unlike most charitable gifts, they offer the opportunity for the donor to receive distributions from the trust for either a period of years, not to exceed twenty or for the lifetime of an individual recipient with the remainder upon the trusts maturity being distributed to charity. Thus, they are useful as a vehicle to provide cash flow after the gift (such as to supplement retirement income). The donor will be entitled to a charitable deduction for the value of the remainder interest which passes to charity. The valuation of that interest depends upon a rather complicated formula based on the value of the assets contributed to the trust, the amount of the payments to the donor, the length of time such payments continue and the federal interest rate under IRC Section 7520.

There are two types of charitable remainder trusts: (i) a charitable remainder annuity trust, which pays the recipient a fixed dollar amount or a percentage of the initial value of the assets in the trust (called an annuity payment); and (ii) a charitable remainder unitrust, which pays the recipient a percentage of the annual value of the assets in the trust (called a unitrust payment). No additional contributions may be made to a charitable remainder annuity trust, while additional contributions may be made to a charitable remainder unitrust.

Generally, charitable remainder trusts are exempt from taxation. This allows the trust to receive the assets transferred in the charitable contribution and to sell such assets without incurring taxable gains. Thus, the full proceeds can be reinvested in other income producing assets which can be invested to produce higher cash flow than the original asset contributed. Charitable remainder trusts are however subject to income tax on all the income in any year that they recognize unrelated business taxable income. As discussed above, such unrelated business taxable income can arise in a couple of ways: (i) upon receipt of income from an activity unrelated to the tax-exempt purposes of the trust (which would essentially be any active income from a business) ; and (ii) from debt-financed income.

b. Gifts of Business Interests to Charitable Remainder Trust S corporation stock may not be held by a charitable remainder trust. A transfer of S corporation stock to such a trust will cause the S election to terminate and the corporation to be taxed as a C corporation. A gift of a partnership interest to a charitable remainder trust is permissible but would only make sense if the trust could in turn sell the interest either back to the partnership or to a third party. The income allocated to the trust by the

partnership while the trust holds the partnership interest could be unrelated taxable income depending upon the type of income. Generally, passive income (dividends and interest) are not unrelated business taxable income. However, income from the sale of inventory or from providing services will likely be unrelated business taxable income, which would cause the trust to be taxed on all of its income that year. Therefore, unless the activities of the partnership are limited to passive ones, such an interest is not suitable for a contribution to a charitable remainder trust. If a partnership interest is transferred to a charity, unless the trustee is not related or a subordinate party to the grantor, the interest must be appraised by a qualified appraiser.

c. Charitable Remainder Trust Established by an S Corporation An S corporation can create a charitable remainder trust for which it is the grantor and the taxable recipient (see PLR 9340043). As the recipient is not an individual, the maximum period that the payments may be made is 20 years. The amount of the charitable deduction will be calculated as described above and the deduction will be allocated to the shareholders on a pro rata basis. The company upon receipt of the unitrust payments may, in turn, distribute such amounts to shareholders. The shareholders will be taxed on such distribution first to the extent of the ordinary income of the trust (dividends and interest), and then as capital gains.

VI. Case Studies The following case studies illustrate various alternatives for accessing assets held by the closely held business with which to make a charitable contribution.

A. ABC Textile Company, Inc.; Gift of Undeveloped Real Estate by S Corporation John Smith is 65 years old and has been a widower for five years since his wife died from breast cancer. He has two children both in their 30s who still live in the community. They were a very close family before his wife's death and have become even closer since. John has been doing a lot of thinking about his life after his wife's death. He has built a successful business but at this point in his life it feels like a done deal situation. He is looking for another kind of meaning in his life. John has always been active on nonprofit boards and has enjoyed giving back to the community. The family gained a great deal from a cancer support group and hospice during his wife's illness so they all feel that giving something back to the community is important. They explored the idea of establishing a private foundation but did not want the administrative hassles. A donor-advised fund at the community foundation offered them the guidance of a trained staff in identifying worthwhile causes, taught them how to make decisions as a family and gave them the best tax advantages.

After talking with his advisor he has decided to make a gift of appreciated undeveloped real estate held by his S corporation.

This company has always been an S corporation, the stock of which is held 50% by John Smith, and 25% by each of his two children. He desires to make a charitable contribution through the company by having it make a gift of appreciated undeveloped real estate. The value of the real estate is \$1,000,000 and it is not subject to any debt. The tax basis of the real estate is \$200,000. He could cause the corporation to distribute such asset to him and his two children as a dividend and then they could make a charitable gift of the real estate. However, such a distribution would cause the corporation to recognize gain of \$800,000 that would be allocated to the shareholders. Thus, that alternative is not a

viable one. Instead, he causes the corporation to directly transfer the real estate to the community foundation for the benefit of the Smith Donor-Advised Fund. The charitable contribution amount is \$1,000,000 without any reductions as it is assumed that the real estate was not held for sale to customers and there is no depreciation recapture associated with the real estate. The deduction is not included in calculating the corporate income for tax purposes. Instead, it is allocated pro rata among the three shareholders. Their ability to use the deduction is limited to the sum of their tax basis in their stock, plus any loans made by them to the corporation. John's basis in the stock is \$900,000 and he has made a loan to the company of \$100,000. Thus, he will be able to use his share of the deduction, \$500,000. John next determines whether there is any individual limit on his ability to deduct the contribution. It is assumed that the charity is a 50% charity, meaning that John could deduct his \$500,000 share of the contribution up to 50% of his contribution base which is his adjusted gross income. In this case, his adjusted gross income is \$300,000, thus he can deduct \$150,000 in the year of the gift and carry forward the excess for up to five years. He will be required to reduce his tax basis in his stock in ABC Textile Company by the amount of deduction. John previously identified a potential buyer of the real estate, although no contract has been negotiated or signed. Following the contribution, the community foundation sells the real estate for \$1,000,000 to the buyer.

B. Carolina Automotive Corporation; Gift of S Corporation Stock Robert Jones has been selling used and new cars for most of his working life. This has kept him very busy working long hours with little time for community involvement. He is at a point in his life now where working 60 hour weeks no longer holds the charm it once did. Jones was smart in business and was smart in picking qualified people to advise him on his estate and tax planning. His accountant and his attorney raised the issue of using some of his wealth to support charitable causes of importance to him and his family. Reluctant at first the idea began to grow on him the more he thought about it. He had come from a mill family that did not have much, he paid his workers well but knew that they often struggled and being in the car business he knew that people often had a difficult time paying their bills or managing their money. Maybe he could use his philanthropy to help people learn more about finances. His advisors put him in touch with the local community foundation. As part of educating him about philanthropy, the staff set up site visits for Jones to visit various organizations involved with financial counseling. In the meantime he met with his advisors to look at possible gifting vehicles.

This company has always been an S corporation. It is in the business of selling new and used automobiles. It is owned 100% by Robert Jones. He has decided that he would like to make a charitable contribution through the company. The company does not have any assets that are particularly suitable to be transferred to a charity. As a result, Robert decides to make a gift of 5% of his stock to a publicly supported community foundation. Following the gift, he will cause the corporation to redeem the stock for its fair market value. Robert obtains an appraisal of the value of the stock which is worth \$250,000. Robert's basis in the 5% stock is \$175,000. The amount of the charitable deduction is adjusted to take into account the ordinary income that would be realized if the corporation sold all of its assets and allocated the various types of gain to the 5% shareholder. In this case, if the company sold all of its assets, it would recognize ordinary income of \$1,000,000 on the sale of its inventory. A 5% share of this ordinary income is \$50,000. Thus, the value of charitable contribution of the 5% stock is reduced by \$50,000 to \$200,000. The charity will hold the stock for a short time before the corporation redeems it.

Its share of S corporation income that year will be subject to tax as ordinary income, as well as the gain on the sale of the stock in excess of the carry over basis of \$175,000. Despite such taxes, the charity has decided it is willing to accept such a contribution as it will net substantial funds after such taxes. Robert creates the Robert Jones Donor Advised Fund at the community foundation. He names himself, his wife and his children to be advisors to the Fund. They continue to participate in giving advice on distributions from the Fund to charities.

C. Smith Family Partnership; Gift of Real Estate by Partnership Tom Smith and his wife enjoy making charitable gifts, but they want to assure themselves that he and his family have as much control as possible over the distributions and the management of the assets given. Thus, they are interested in a private foundation.

Tom Smith and his family established a limited partnership a couple of years ago. Tom and his wife, Mary, are each 2% general partners and each holds limited partnership interests of 20%. The remaining 56% limited partnership interests are held by their two children equally. The partnership holds one residential rental property with a value of \$300,000 and a basis of \$100,000. It also holds an undeveloped parcel of real estate with a value of \$220,000 and a basis of \$200,000. There is no debt on either property. Tom would like to make a charitable contribution of one of his properties to a private foundation established by he and his wife. His children are also on the board of directors. He has identified a buyer for either property, but no contract has been signed. In considering which property to have the partnership contribute, his tax advisor reminds him that he used the accelerated method of depreciation on depreciating the rental property. Upon a sale of that property, \$120,000 of such accumulated depreciation would be recaptured. As a result, if the partnership contributes that property, the value of the \$300,000 gift would be reduced by \$120,000, thus the value of the charitable gift would only be \$180,000. There would be no depreciation recapture on the undeveloped real estate as no depreciation has been taken; therefore, Tom instead selects the undeveloped lot with which to make the contribution. Because the lot is appreciated, the value must be reduced by 100% of the long term capital gain of \$20,000, thus the value of the gift is \$200,000. The partnership transfers the lot to the private foundation and reports the \$200,000 deduction to the partners based upon an appraisal. The pro rata share of the charitable deduction allocated to Tom and Mary, who file a joint tax return, is \$88,000 (44%). The remainder of the deduction is allocated equally to the two children. Tom and Mary's tax basis in their interest in the partnership totals \$110,000. The partnership has no debt. Tom and Mary reduce their tax basis in their partnership interest by their share of the partnership's basis in the real estate contributed (\$88,000). They can deduct the gift of appreciated property to the private foundation up to 20% of adjusted gross income which is \$130,000. Thus, they can deduct \$26,000 this year and carry the balance forward. Following the gift of the real estate to the private foundation, it enters into a contract to sell the real estate for \$220,000. As the foundation is exempt from income tax, no gain is recognized by the foundation. Tom, his wife and children continue to manage the private foundation and make distributions from it to other charities.

D. Jones Plumbing Supply, Inc.; Transfer by S Corporation of Publicly Traded Stocks to Charitable Remainder Trust William and Mary Jones are in their late fifties. They created Jones Plumbing Supply, Inc. business twenty years ago. They have sent their two children to school and look forward to having

more time to travel and possibly retire early. The Joneses have been very involved for many years with the local literacy program where they have volunteered as mentors for adult learners. As part of their annual review with their accountant they talked about both of these issues. The accountant had a suggestion that provided them with additional income and could help them support the literacy program a charitable remainder trust with the remainderman going to a designated fund at the community foundation.

Jones Plumbing Supply, Inc. has always been an S corporation. It is owned equally by William Jones and his wife, Mary. The company has accumulated a substantial amount of publicly traded stocks which have appreciated but pay very low dividend yields of an average of 1.5% or \$3,000 per year. William and Mary would like to access this stock portfolio with current value of \$200,000 and a tax basis of \$80,000 for use in making a charitable deduction. They are interested in having the company transfer the stock to a charitable remainder trust which could pay a unitrust amount to supplement the income they derive from the business. The charitable remainder trust is attractive because it allows the stocks to be sold and reinvested on a tax-free basis. William causes the company as grantor to create a charitable remainder unitrust to which the company transfers the stock portfolio with a value of \$200,000. The trust agreement provides that it will pay a unitrust amount of 6% to the company for a period of 20 years. At the end of the term, the remainder of the trust assets will be distributed to their local community foundation to be added to the William and Mary Jones Fund For Literacy, a designated endowment fund to benefit the local literacy agency. Assuming the IRC Section 7520 rate is 4.5%, a charitable deduction of \$60,112.40 will be allocated between William and Mary. In addition, for the next 20 years, on a quarterly basis, the company will receive a unitrust amount equal to 6% of the annual value of the assets in the charitable remainder trust. Upon receipt of such payments, the company will in turn make distributions to William and Mary, or to the survivor. The trust sells the stock portfolio tax-free and reinvests the entire proceeds in a bond fund paying 6.2%. William and Mary have increased their cash flow from the portfolio from \$3,000 per year to \$12,000 in the first year. They also benefit from the tax savings from the charitable deduction of \$60,112.40. As the community foundation is a 50% charity, but the asset is long term capital gain property, William and Mary can deduct the charitable contribution up to 30% of their contribution base (adjusted gross income) and carry forward for five years any excess. William and Mary reduce the tax basis in their stock in Jones Plumbing Supply, Inc. by the amount of the charitable deduction.

E. Raleigh Air Conditioning Company, Inc.; Transfer of C Corporation Stock To A Charitable Remainder Unitrust

John Freeman owns 30% of the outstanding stock of Raleigh Air Conditioning Company, Inc., a C corporation. He has previously transferred the remaining 70% of the stock to his two sons who work in the business. John wants to achieve a number of goals with regard to his remaining stock: (i) make a gift to his university's supporting foundation; (ii) make sure that control over the business remains with his children; and (iii) retain some cash flow from the interest he now has in the business. John then decides to establish a charitable remainder unitrust and transfer to it the 30% stock that he owns. He will obtain an appraisal from a qualified appraiser. Upon transfer of the stock, the company will redeem such stock for cash and the trust will reinvest the proceeds without income tax. In order to avoid self-

dealing rules under IRC 4941, all the shares must be offered the same redemption terms. (See Treas. Reg. Section 53.4941(d)-3(d) (2), Example 2) (Also see Rev. Rul. 78-197, 1978, CB 83). The trust will pay John a unitrust amount for his life. Following the redemption, all the outstanding stock will be held by the two children. John will be entitled to a charitable income tax deduction for the value of the remainder interest passing to the foundation. Thus, John has achieved his goals of making a charitable gift to the university foundation, removed the stock from his estate, obtained cash flow from the business interest, and made sure that his sons continue to own the business. In order to replace the value of the stock that will eventually pass to the foundation rather than to his children, John uses some of the cash flow from the trust to make gifts to an irrevocable life insurance trust which has purchased a second-to-die life insurance policy on the joint lives of John and Mary. Upon the death of the second of them, the insurance trust will collect the proceeds and it will be distributed to their sons and will be excluded from the estates of John and Mary for estate tax purposes.