Charitable Donations of LLC and Limited Partnership Interests to Nonprofits

MONDAY, NOVEMBER 21, 2022, 1:00-2:50 pm Eastern

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November 21, 2022

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Strafford Webinars
November 21, 2022

Contributions of LLC and Limited Partnership Interests to Charitable Organizations

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Introduction

- Individuals can create attractive tax planning opportunities through charitable transfers of interests in businesses or investments taxed as partnerships, such as LLC interests or limited partnership interests.
- Exempt organizations must have a solid understanding of the consequences of a contribution of an LLC interest or limited partnership interest to both the donor and the donee organization.
- Private foundations must also be aware of the additional tax implications of the contribution of an LLC interest or limited partnership interest.

Types of Legal Entities

- Different legal entities can be used to form a business:
  - Corporation
  - Partnership
    - General Partnership
    - Limited Partnership ("LP")
  - Limited Liability Company ("LLC")

Tax Status of Legal Entities

- Legal entities can have a different tax status:
  - C Corporation
  - S Corporation
  - Partnership
  - Disregarded Entity

Key Concerns for Charity and Donor

- Liquidity and Timing
- Transferability
- Potential Liabilities
- Gift Acceptance Policies
- Tax Issues
- Valuation

Liquidity and Timing – Donor Strategies

- Common strategies for contributions of LP or LLC interests:
  1. **Contribution Before Sale:** If a donor intends to sell their entire business to a third party, the donor can contribute a portion of the LP or LLC interest to a charity before the third party sale in order to meet their philanthropic goals while avoiding capital gains tax on the contributed interest.
  2. **Contribution and Redemption:** A donor may contribute an LP or LLC interest with the intention (but not the legal requirement) that the company will redeem the charity's interest a short period of time after the contribution.
  3. **Contribution of Cash Flows:** A donor may contribute an LP or LLC interest that generates current cash flow even where there is no contemplated liquidity event.

Liquidity and Timing – Charity Goals

- **Exit Strategy:** The charitable organization generally would like to have an exit strategy to convert a contributed interest into cash to fund its activities or its endowment.
- However, if the LP or LLC is producing current cash flow, the charity may choose to hold onto the contributed interests.

Transferability – Charity Diligence

- LP and LLC operating agreements usually contain restrictions on transferring interests.
- **Tag Along Rights**: The charitable organization should make sure that the operating agreement provides for a “tag along” right under which the charity could sell its interest under the same conditions as the donor or other majority owners of the company.
- **Forced Sales:** The charitable organization should also review the operating agreement to understand when it could be forced to sell and at what price (i.e., a “drag along” provision).

Potential Liabilities – Charity Concerns

- **Cost and Effort:** Accepting a contribution of an LP or LLC interest requires a significant amount of due diligence, review and cost.
- **Limited Rights:** The charitable organization may have different rights with respect to the company than the donor has – for example, the charity may only be a non-voting member or an assignee.

Potential Liabilities – Charity Diligence

- **If Holding Interest:** If the charitable organization will hold the LP or LLC interest for a period of time, the charity should review the governing documents carefully to confirm the charity's rights and obligations.
- **If Selling Interest:** If the company is being sold to a third party, the charitable organization will become a party to the third-party deal. The charity will be required to engage attorneys to review the sale documents and provide any required legal opinions.

Potential Liabilities – Charity Diligence

- **Diversification:** In the case of an investment entity, the charitable organization should consider the type of assets held by the LP or LLC and whether portfolio is diversified.
- **Regulatory Concerns:** Interests in certain businesses (such as a healthcare entity) may subject the charity to government regulation.
- **Publicity:** Interests in other businesses (such as an alcohol or tobacco distributor or a casino) may create unwanted attention or publicity.

Potential Liabilities – Required Payments

- **Capital Contributions:** The operating agreement for the LP or the LLC may contain a capital contribution requirement (including cram-down provisions for failure to fund).
- **Clawbacks:** There also could be a requirement under the operating agreement to return prior distributions (referred to as a "clawback" obligation).

Liability Protection

- While LPs and LLCs generally provide liability protection for their owners, creditors of the company may attempt to “pierce the corporate veil” and look to the owners to pay the company’s liabilities if the business if not operated correctly.
- Consider type of interest being donated – general partner interest vs. limited partner interest.
- A charitable organization should consider holding the donated interest through a wholly-owned LLC.

Gift Acceptance Policies

- Gift acceptance policies (“GAPs”) are not mandated by tax law or other legal requirements, but are a good governance practice for charitable organizations of any size.
  - Form 990 Schedule M (Noncash Contributions) asks whether organization has a GAP that requires review of any “nonstandard” donations.
- **Purpose:** Ensuring organization does not take on business or tax responsibilities, or potential liabilities, that it may not want.
- **Approval:** GAPs are typically approved at the governing board level.

GAP – Common Terms

- **Small or Cash Gifts:** Authorizes staff, or specified staff members, to accept cash gifts or gifts below a certain dollar amount.
- **Larger Gifts:** Requires further review of gifts above certain dollar limits, or gifts other than cash or publicly traded securities.
  - A gift of a business interest, such as a LP/LLC interest, would typically require review under a GAP.
- **Review Procedure:** Creates a review procedure for the governing board committee, high level executives, or both.

GAP – Affected Gifts

- Gifts potentially subject to review under the GAP:
  - Real estate;
  - Any restricted or conditional gifts;
  - Business interests including LP/LLC interests;
  - Closely held stock;
  - Automobiles, artworks and other tangible personal property;
  - Life insurance policies; and
  - Patents and copyrights.

Tax Issues – Key Benefits

- **Key Tax Benefits For Donors**: For contributions of appreciated property (including LP/LLC interests), the key tax benefits are
  - Avoiding recognition of the gain; <u>and</u>
  - Obtaining an section 170 deduction for full FMV of the property. (“Section” references are to the Internal Revenue Code of 1986, as amended.)
- Donating LP/LLC interests to a charitable organization prior to a sale minimizes capital gains tax that would have been incurred on the sale of the donated interests.

Public Charity vs. Private Foundation

- Charitable organizations are presumed to be private foundations unless they qualify to be treated as a public charity.
- **Private Foundations:** They are charities that receive their primary financial support from a few individuals and/or corporations, or from income earned by their own endowments.
- **Per Se Public Charities:** Churches, hospitals, and educational organizations.
  - Rev. Rul. 98-15: IRS found that a hospital that transferred all of its assets to an LLC would still be recognized as a public charity.
- **Other Public Charities:** Generally other charitable organizations that are broadly publicly-supported, government supported, or supported by income from charitable activities, or those that support another public charity may qualify to be public charities themselves.

*FMV determined by qualified appraisal

Public Charity vs. Private Foundation

- Donating to a public charity (including a donor-advised fund) versus a private foundation has the following tax advantages:

Public Charity	Private Foundation
Income tax deduction equal to fair market value of donated property on the date of contribution.*	Income tax deduction limited to tax basis of donated property.
Contributions of appreciated property generally deductible up to 30% of donor's AGI.	Contributions of appreciated property limited to a deduction up to 20% of donor's AGI.

*FMV determined by qualified appraisal

Public Charity vs. Private Foundation

- The same tax advantages apply if the contribution is made to an LLC that is wholly-owned by a public charity and is treated as a disregarded entity for income tax purposes (Notice 2012-52).
- Other public charity advantages:
  - Public charities are not subject to a mandatory annual grant distribution requirement.
  - Public charities are not subject to an excise tax on net investment income.
  - The excess business holding rules do not apply to public charities (except for donor advised funds and certain supporting organizations).

Contribution of Interests That May Be Acquired and Assignment of Income

- Questions as to whether a donor can avoid the recognition of gain by contributing LP/LLC interests to a charitable organization arise when the contributed property may be acquired in the near future.
- **Pre-Arranged Sale Rule:** if a donor enters into an agreement to sell appreciated LP/LLC interests and then contributes the property to a charitable entity, the IRS may recharacterize the transaction as a taxable sale followed by a charitable contribution of the proceeds.
- **Legal Standard for Recharacterization:** *taxpayer-friendly* "bright-line test:"
  - Under Revenue Ruling 78-197, the IRS will apply the pre-arranged sale rule only when the donee is *legally bound or can be legally compelled* to sell the property before the contribution is made.

Assignment of Income

- The general principle of Rev. Rul. 78-197, which relates to donations of closely held corporate stock, applies to donations of LP/LLC interests, but details of the LP/LLC structure should be considered.
  - See PLR 201012050 (12/20/09); IRS CCA 201507018 (9/16/14).
- **Issue – Practically Certain Sales:** If the contribution of a business interest is made when the sale is "practically certain," there is risk that the IRS may still recharacterize the transaction as sale and subsequent contribution and seek to have donor recognize the gain on the contributed interest.
  - See, e.g., Dickinson v. Commissioner, 2020 RIA TC Memo 2020-1211 (2020); Rauenhorst v Commissioner, 119 TC 157 (2002); Palmer v. Commissioner, 62 T.C. 684 (1984);
- Thus, it can be helpful to let some time pass (months?) between when the contribution is made and when the sale of the interest to a third party is finalized and legally binding.
  - Especially true when the donor controls the sale.

Deduction Amount

- The amount of the allowable deduction for the charitable contribution of an LP/LLC interest, depends on whether the underlying property is ordinary income property or capital gain property.
- **Ordinary Income Property:** Deduction is limited to the fair market value of the contribution less the amount that would be recognized as ordinary income in a hypothetical sale of the property.
  - This generally limits the contribution deduction to the basis in the property.
  - Ordinary income property is also known as section 751 “hot assets”, and includes unrealized receivables, appreciated inventory, and depreciation recapture.
- **Capital Gain Property:** Deduction is the fair market value of the contributed property

Bargain Sales Overview

- **Bargain Sale:** When a partner contributes property (including LP/LLC interests) to a charity and receives consideration in exchange, but the total amount realized by the donor is less than the fair market value of the interest contributed, the transfer is classified as a "bargain sale."
  - Consideration can include receipt of property or cash or relief from indebtedness.
- In such case, the transaction is treated as partially a gift and partially a sale. The total amount realized is treated as a sale and is subtracted from the fair market value of the interest. The difference is treated as a charitable contribution.

Indebtedness in Bargain Sales

- **Relief from Indebtedness is Consideration:** If an LP/LLC interest is transferred to a charity subject to indebtedness, the amount of indebtedness is treated as an amount realized on the transfer, regardless of whether or not the charity agrees to assume or pay the indebtedness.
- To the extent the donor's share of liabilities is in excess of the donor's basis in the contributed partnership interest, the contribution may result in a deemed distribution of cash to the donor.
- This can cause the contribution to be treated as a bargain sale and the realization of "phantom income".
- Gain recognition usually occurs when the partner has a negative capital account.

Adjusted Basis in Bargain Sales

- **Determining Gain on the Sale Portion:** under section 1011(b), the adjusted basis of the sale portion for purposes of determining gain on such sale is:

$$Total\ Adjusted\ Basis\ x\ \left(\frac{Amount\ Realized}{Property's\ FMV}\right)$$

- The remaining charitable contribution deduction flows through to the partners, subject to any limits on the contribution contained in section 170(b).

Bargain Sale Example

Taxpayer contributes an LLC or partnership interest to a charitable organization in exchange for **$600** ($400 in cash + $200 share of nonrecourse liabilities)

- FMV = **$1,000**
- Adjusted Basis = **$300**
- Nonrecourse Mortgage Liability = $200*

<u>The taxpayer's gain on the bargain sale is **$420**</u>

- Proportional sale basis = ($600 amount realized/$1,000 FMV) x $300 adjusted basis = $180.
- $600 amount realized - $180 proportional basis = $420.

<u>The taxpayer is deemed to have made a charitable contribution of **$400**</u>

- $1,000 FMV - $600 amount realized = $400.

* Note that the nonrecourse mortgage liability is considered an amount realized in the same way as the additional cash consideration that is paid to the taxpayer.

Strategy for "Burned Out" Shelters

- **Issue:** Investments in "burned out" shelters (which often involve subsidized low-income housing) can saddle limited partners with annual allocations of phantom income, without distributions of cash flow.
- **Strategic Solution:** Under these circumstances, it is often good strategy for the partnership to transfer the property to a charitable organization in consideration for cash, with the charity taking subject to a HUD-insured mortgage.
- **Bargain Sale:** If the property can be appraised at an amount substantially in excess of the purchase price, each limited partner in the partnership may be entitled to a current charitable contribution deduction for the bargain sale transaction.

Bargain Sales and Like Kind Exchanges

- The "like kind" exchange rules of section 1031 and/or opportunity zone fund structure may apply to minimize the tax liability triggered by the sale portion of bargain sales while still preserving the charitable deduction on the gift portion.
- **Like Kind Exchange Rules:** No gain or loss is recognized when property held for productive use in a trade or business or for investment is exchanged solely for property of a like kind and held for similar use.
  - The exchange must meet a 180-day time limit for the exchange and a 45-day time limit for identification of the property being received.

Bargain Sales and Opportunity Zone Funds

- **Section 1400Z-1 and 1400Z-2**
  - Encourages economic growth in distressed communities.
  - Temporary deferral of inclusion in gross income for capital gains invested in a qualified opportunity fund (“QOF”).
  - **Primary Benefit:** exclusion from gross income on investments in QOFs held for at least 10 years.
  - Opportunity zone reforms are anticipated regarding reporting, modifying the certification process, extending deferral of inclusion of gross income, allowing feeder funds, eliminating higher-income census tracts, and tasking treasury with proper oversight.
  - **Working capital safe harbor:** a valuable tool including the 2021 corrective amendment and the impact on substantiality test.
  - How to stimulate investment in affordable housing.

Bargain Sales and Opportunity Zone Funds

- Tax Incentive Benefits:

Gain Deferral	Forgiveness of Additional Gains

Bargain Sales and Opportunity Zone Funds

- **Comparing section 1031 to opportunity zone tax benefits:**

Opportunity Zone	Section 1031
Investments are not restricted to real estate. They are available to all capital gains, such as hedge funds.	Deferral regime applies only to real estate.
Provides a permanent basis step-up if held for 10 years.	Provides a permanent basis step-up only at death.
Deferral only requires reinvestment of the "capital gain" portion, and it does not need to be offset by capital losses.	Exchange needs to cover the "gross" sales proceeds, not just the capital gain.

Bargain Sales and Opportunity Zone Funds

- **Strategy for “busted” 1031**: an opportunity zone business property (“OZBP”) investment may be available in the event of a “busted” 1031 exchange, provided the 180-day period has not expired.
- Alternatively, a QOF or OZBP investment may do a 1031 rollover, but it will need to meet the “substantial improvement test,” which may be difficult to satisfy at a later point in the investment.

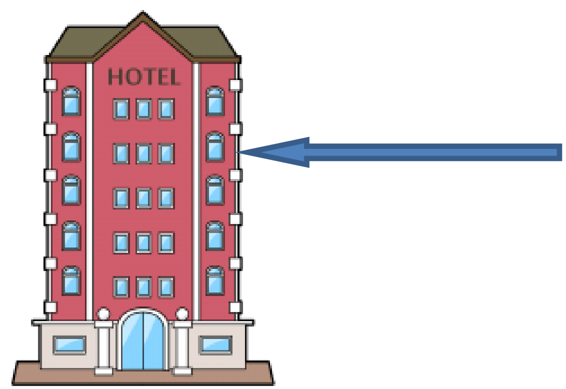
Bargain Sales and Private Foundations

- Any sale, including a bargain sale, between a private foundation and a disqualified person is a prohibited act of self-dealing subject to unwinding and excise taxes on parties to the transaction.
  - A disqualified person may include a participating "foundation manager" as defined in section 4946(a), e.g., an officer, trustee, or substantial contributor.
  - Regulations section 53.4941(d)-2(a)(1) provides that a sale of stock or other securities by a disqualified person to a private foundation in a bargain sale is treated as an act of self-dealing regardless of the amount paid.

Contribution of Partial Interests

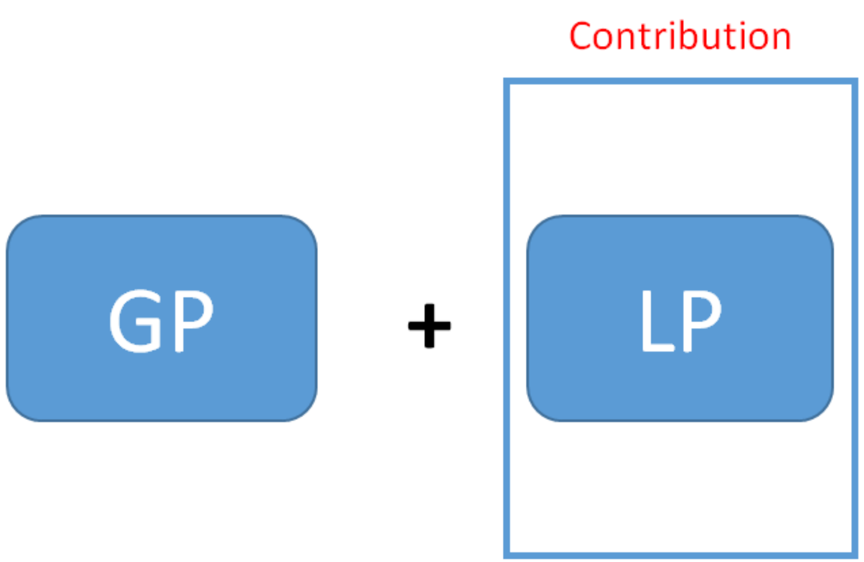
- **No Deduction:** A deduction is not permitted when a person contributes only part of their LP/LLC interest (contribution of partial interest) rather than the entire LP/LLC interest.
  - A deduction is also disallowed where a property was subdivided for the purposes of circumventing this rule.
- A partial interest includes:
  - The right to use property.
  - An income interest in a property, etc.

- **Example**: If a donor owns a multi-level building and contributes the right to rent-free use of one level of the building.



Contribution of Partial Interests

- **Query**: If a partner has both a general and limited partnership interest in a partnership and only contributes one of these interests (less than his entire ownership), is this a contribution of a partial interest?



Contribution of Partial Interests

- Section 170(f)(3)(A): “In the case of a contribution (not made by a transfer in trust) of an interest in property which consists of less than the taxpayer's entire interest in such property, a deduction shall be allowed under this section only to the extent that the value of the interest contributed would be allowable as a deduction under this section if such interest had been transferred in trust.”
- Section 170(f)(3)(B)(ii): Subparagraph (A) shall not apply to – “a contribution of an undivided portion of the taxpayer's entire interest in property.”

Valuation and Appraisals

- **Donee organization's perspective.** In general, the best practice for an organization that receives a noncash donation is not to participate in, or ratify, the donor's valuation of the property for deduction purposes.
  - Provide the required contemporaneous written acknowledgment to the donor *describing* (not valuing) the property.
  - Sign Form 8283 as required, which again does not include any ratification of the donor's valuation.
- **Donor's perspective.** A contribution of an LP or LLC interest for which a section 170 deduction of $5,000 or more is taken must be supported by a *qualified appraisal* of the donated interest, prepared by a *qualified appraiser*. See section 170(f)(11)(C), (E).

Qualified Appraisal Requirements

- Regulations section 1.170A-17(a)
- **Preparation:** By a "*qualified appraiser*" in accordance with the standards of the Uniform Professional Appraisal Practice. Qualified appraiser must provide:
  - Contact information, qualifications in valuing the relevant type of property, capacity in which they are acting, and signature;
  - Acknowledgement of potential penalties for substantial valuation misstatements; and
  - Affirmation that they are not barred from practicing before the IRS.
- **Timeline:** Completed/received by donor no earlier than 60 days before donation and no later than donor's return due date.
- **Fees:** Contingent fees prohibited.

Qualified Appraisal Content

– **Content:**
  - Sufficiently detailed description, including the condition of the property, such that an outside party can ascertain that the appraised property is the contributed property;
  - FMV on the valuation effective date (no earlier than 60 days before donation or later than the contribution date), method of valuation, and specific basis and justification for valuation (e.g., comparable transactions or statistical sampling);
  - Description of any restrictions on the donee's use of the property and any rights in the property retained by or conferred on others (including voting rights, acquisition rights, designation rights);
  - Contribution date; and
  - Statement that the appraisal is for tax purposes.

Qualified Appraiser Qualifications

- Regulations section 1.170A-17(b)
- **Education and Experience:** Two paths:
  1. Successfully completing professional or college-level coursework in valuing the relevant type of property with at least 2 years of experience in valuing such property.
     - Must be from (A) professional or college-level educational organization, (B) professional trade or appraiser organization that regularly offers the educational programs, or (C) employer apprenticeship or educational program similar to those in (A)-(B).
  2. Earning appraiser designation for the type of property from a recognized professional appraiser organization for demonstrated competency.

Qualified Appraiser Disqualifications

– **Disqualifications:**
  - Receiving contingent fee for appraisal;
  - Interested/related parties to the transaction (including the donor or donee, parties interested in the transaction in which donor acquired the property, and independent appraisers regularly used by any interested party); or
  - Individuals prohibited from practicing before the IRS.

Tax Reporting – Donor Substantiation

- **Contemporaneous Written Acknowledgment ("CWA"):** Donors must receive a CWA of the contribution from the donee organization in order to receive a deduction under section 170(f)(8).
  - Due to the donor on or before return filing or due date.
  - Required for section 170 deductions of $250 or more.
- **CWA contents:**
  - Amount of cash and a description (but not value) of noncash contributions.
  - Whether donor received any goods or services in consideration of the contribution, and if so, a good faith estimate of the value of such goods or services.
- **IRS Challenges:** IRS in recent years has challenged very large section 170 deductions because they lacked a technically compliant CWA, even where other detailed documentation confirms the donation.
  - Form 8283 (see below) does not qualify as a CWA.
  - See, e.g., Izen v. Commissioner, 148 TC 71 (2017); Irby v. Commissioner, 139 TC 371 (2012).

Tax Reporting – Filings

- **IRS Form 8283:** identifies and describes noncash contributions.
  - Attached to donor's tax return.
  - Supports, among other things, a section 170 noncash charitable contribution deduction of $500 or more, including for contributions of LP/LLC interests.
  - Donee organization must sign the Form 8283 to confirm receipt of the property.
  - Appraiser must sign the Form 8283 for each donation for which a qualified appraisal is required.
  - Copy of qualified appraisal must be included with Form 8283 for contributions valued at $500,000 or more.
  - The donee organization must file Form 8282, with copy to donor, if it disposes of the donated property within three years of receipt.
- **Form 990, Schedule M**: filed by donee organization. Identifies noncash contributions *and provides value estimate*.
  - Does IRS cross-reference Schedule M and Form 8283?

Excess Business Holdings & Private Foundations

- Under the section 4943 excess business holdings rule, a private foundation is permitted to hold only limited interests in unrelated business enterprises.
  - The rule only applies to private foundations (and donor advised funds and certain supporting organizations), not public charities.
- **Purpose:** The purpose of the excess business holdings rule is to prevent tax exempt organizations from competing unfairly with taxable businesses, while still permitting them to engage in passive investment activities.
- **Penalties:** A private foundation is penalized with an excise tax if the foundation has excess business holdings.

Excess Business Holdings Rule

- **General Rule:** with regard to an incorporated business enterprise, the general rule is that a private foundation and all disqualified persons together may not own more than 20% of voting stock.
  - Nonvoting stock is permitted, but only if all disqualified persons together do not own more than 20% of the voting stock.
  - Similar rules exist for partnerships, joint ventures, and LLCs.
  - No holdings are permissible in the case of a business enterprise operated in sole proprietorship form.
- **Business Enterprises:** The rules only prohibit excess holdings of "business enterprises." The following do not qualify as a "business enterprise:"
  - A trade or business that is not an "unrelated trade or business" (as defined in section 513); or
  - Any trade or business at least 95% of the gross income of which is derived from "passive sources."

Avoiding Excess Business Holdings (cont'd)

- If a section 501(c)(4) organization is controlled by one or more disqualified persons, it would be permissible for a private foundation and the section 501(c)(4) organization to enter into transactions that ordinarily would be treated as self-dealing.
- For example, a section 501(c)(4) organization could:
  - Purchase or borrow assets from a related private foundation;
  - Lease real estate to a related private foundation; or
  - Co-own and co-invest with a related private foundation.

Excess Business Holdings – Disqualified Persons

- Holdings are determined with reference to the foundation's own holdings and holdings of all "disqualified persons," including:
  - Substantial contributors;
  - The foundation manager;
  - More than 20% owners of substantial contributors;
  - Family members of the above persons;
  - Corporations, trusts, or partnerships that are more than 35% owned by the above persons; and
  - Other private foundations:
    - That are effectively controlled by the same persons who control the foundation for which the excess business holdings rule is being applied, or
    - Substantially all contributions to which were substantially made by the above persons.

Excess Business Holdings Tax

- **First Tier Penalty:** A 10% excise tax is imposed on excess business holdings on the last day of the foundation's taxable year.
  - Calculated for each enterprise and based upon the amount of excess holdings on the day when excess holdings were largest.
  - The excise tax does not apply if the foundation disposes of the excess holdings within 90 days after it knew or should have known of the holdings.
- **Second Tier Penalty:** An additional tax of 200% of the value of the excess holdings will also be imposed if the excess holdings are not disposed of by the close of the taxable period.
  - **Correction Period:** No additional tax is assessed if excess holdings are reduced to zero within the "correction period" (90 days after a deficiency notice).

Disposition of Certain Excess Holdings

- **Grace Period:** A private foundation that acquires excess business holdings, other than as a result of a purchase by the foundation, will not be subject to the taxes on excess holdings if it disposes of the excess holdings within 90 days from the date on which it knows, or has reason to know, of the event that caused it to have the excess holdings.
  - **Extension:** This 90-day period will be extended to include the period during which a foundation is prevented by federal or state securities law from disposing of the excess business holdings.
  - The amount of holdings the foundation must dispose of is not affected by disposals by any disqualified persons during the 90-day period.
- **Example:** The 90-day disposition period applies when a disqualified person acquires additional holdings, pushing the foundation's holdings over the limit. The foundation must dispose of the excess holdings within 90 days, regardless of whether the disqualified person disposed of its own holdings already.

Avoiding Excess Business Holdings

- Section 4943 precludes a private foundation from long-term ownership of more than 20% of the voting stock of a corporation or other business enterprise in combination with a disqualified person.
- **Solution:** However, if a section 501(c)(4) organization is not a disqualified person, it could own a “business enterprise” with one or more private foundations in a way that would avoid violating the prohibition against excess business holdings.
- **Strategy:** An owner of interests in a closely-held business could transfer their interests to both a private foundation and a section 501(c)(4) organization at the same time so that only 20% of the voting stock is held by the private foundation and 80% is held by the section 501(c)(4) organization, thus avoiding excess business holdings.

Unrelated Business Income Tax

- Organizations normally exempt from tax under section 501 are subject to the "unrelated business income tax" ("UBIT").
- Tax-exempt corporations are subject to UBIT at regular corporate rates (at present, 21%).
- Tax-exempt trusts are subject to UBIT at regular trust rates:
  - Up to 37% for ordinary income.
  - Up to 20% for long term capital gain and qualified dividend income.

Sources of Unrelated Business Taxable Income

- **Active businesses:** Gross income (net of directly related deductions) derived from any trade or business that is:
  - "Not substantially related" to the organization's exempt function; and
  - "Regularly carried on" by the organization.
- **Debt-financed Income:** Capital gains, interest, dividend and other income normally excluded from unrelated business taxable income ("UBTI") are nevertheless treated as UBTI to the extent the property generating the income is financed by debt.
- **S Corporation Income:** All items of income, loss, or deduction and any gain or loss from the disposition of the S Corporation stock is UBTI.

Exclusions from Unrelated Business Taxable Income

- Unless derived from debt-financed property or controlled organizations:
  - Gains from sale of stock and other property (except property held for sale to customers in unrelated business);
  - Interest;
  - Dividends;
  - Certain rents;
  - Royalties;
  - Annuities;
  - Income from notional principal contracts; and
  - Securities lending transactions.

Unrelated Business Taxable Income – Income from LP/LLC Interests

- **Operating Income:** A charitable organization will be subject to UBIT on LP and LLC operating income allocated to it on an item-by-item basis.
  - UBIT applies as if each category of income generated by the LP or LLC was generated by the charity itself.
- **Disposition of LP/LLC Interests:** Gain from the sale of an LP or LLC interest is treated generally as capital gain and not subject to UBIT.
  - Exclusions to this rule apply for (i) debt-financed property and (ii) interests that would be inventory in the hands of the charitable organization or property held for sale to customers of the charitable organization and (iii) interests that trigger depreciation recapture.

Unrelated Business Taxable Income – Debt Financed Income

- A percentage of the income derived from property as to which there is "acquisition indebtedness" during the applicable period will be subject to UBIT.
  - **Acquisition indebtedness:** indebtedness that is incurred by the tax-exempt organization in acquiring the property or that would not have been incurred but for the acquisition.
  - The amount subject to UBIT is the debt/basis percentage for that property for the year:

$$\%\ Subject\ to\ UBIT = \frac{Average\ Acquisition\ Indebtedness}{Average\ Adjusted\ Basis}$$

  - In the case of gain or loss from the sale of the property, the average acquisition indebtedness is the highest amount of acquisition indebtedness during the 12-month period ending with the date of sale.

Unrelated Business Taxable Income – Debt Financed Income

- For a charitable organization that receives a contribution of LP/LLC interests, the share of debt incurred by the LP or LLC that is allocated to the charity is taken into account in determining the charity’s debt-financed UBTI.
- **Exceptions:** Certain exceptions to these rules may apply with respect to LPs or LLCs that hold real estate.
  - Real property debt of qualified organizations.
  - Certain property subject to a mortgage that is acquired by gift, bequest or devise.

Unrelated Business Taxable Income – S Corporations

- Background
  - An LLC can elect to be treated as an S corporation for income tax purposes.
  - A charity can hold shares in an S corporation without it losing its S corporation status.

Unrelated Business Taxable Income – S Corporations

- **S Corporation UBTI:** As an S corporation shareholder, a charity would be subject to UBIT on its share of *any income* generated by the S corporation (regardless of the type of income).
  - Including gain from the sale or redemption of its S corporation shares.
  - A distribution to the charitable organization in excess of its tax basis in its S Corporation shares also would be subject to UBIT.

Unrelated Business Taxable Income – S Corporation Strategies

- In many cases, because an individual benefits from the reduced long-term capital gains rate, it is better for the individual to sell the shares and contribute the cash net of tax to the charity.
- A donor also should consider having the S corporation itself make a gift of an appreciated capital asset.
  - The charitable deduction will be allocated proportionally to the shareholders.
  - Each shareholder may take a deduction equal to the sum of:
    - Their pro rata share of the S corporation's adjusted basis of the capital asset contributed to the charity, to the extent of the shareholder's basis in the S corporation stock; *plus*
    - Their pro rata share of the appreciation of the contributed capital asset at the time of contribution.

UBIT – Phantom Income from LPs and LLCs

- A charitable organization will be required to pay UBIT on its share of any UBTI from an LP or LLC, irrespective of whether it receives any distributions.
  - The charity should review the operating agreement to determine whether it provides for "tax distributions."
  - The value of any gift to the charity is equal to the amount it receives *net of tax* (and any other costs).
    - Care must be taken to include the cost of any UBTI liability in determining the level of donor recognition or meeting a target for a capital campaign.

Unrelated Business Taxable Income – Tax Exemption and Returns

- A charitable organization also needs to monitor its UBTI because it could lose its tax-exempt status if UBTI comprises a "substantial" portion of its income.
- The charitable organization should confirm that it will receive from the LP or LLC adequate information for it to prepare federal and state UBIT returns (including estimated returns).

Charitable Remainder Trusts

- Charitable remainder trusts (“CRTs”) are generally beyond scope of this presentation, but in general a CRT is a tax-exempt trust that allows a donor to deduct the current actuarial value of property donated to the trust, while retaining an income interest for life or a term of years. When life/term interest ends, the remainder is transferred to charity.
  - IRS has published, and regularly updates, pre-approved safe harbor trust agreement forms for CRTs. See Rev. Procs. 2005-52 through -59.
- In general, LP/LLC interests can be contributed to CRTs. Often, the donor will want to contribute the appreciated interest to a CRT, and then have the trust dispose of the property on a tax-exempt basis.

Charitable Remainder Trusts – Concerns and Complications

- CRTs are subject to a 100% excise tax on unrelated business taxable income, which complicates the holding of LP/LLC business interests in a CRT.
- If the LP/LLC interest is subject to acquisition indebtedness, it will almost automatically generate UBTI and trigger the 100% excise tax if placed in a CRT.
- CRTs are subject to the self-dealing rules, which restrict trustees, donors, and beneficiaries transacting with the LP/LLC even at fair market value.
- May require an independent "qualified appraisal" every year in order to compute the unitrust payout amount.

QUESTIONS?

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