GIFTS FROM SUBCHAPTER S CORPORATIONS AND THEIR SHAREHOLDERS

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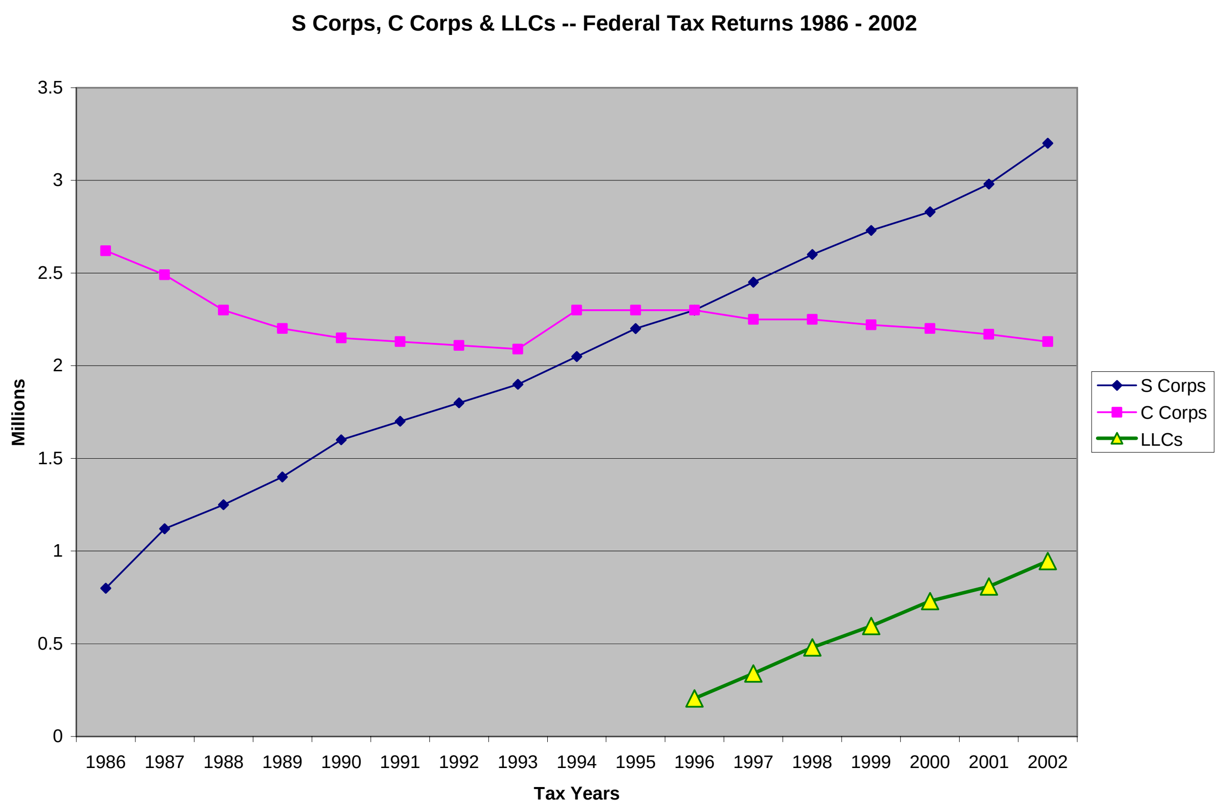
I. INTRODUCTION

If a transaction is not properly planned, more tax can be paid when S corporation stock is owned and sold by a tax-exempt charity than if it is owned and sold by the contributing donor, which frustrates Congressional policies of encouraging charitable gifts and having charities devote resources to charitable purposes. With over 3 million S corporations and nearly 6 million shareholders, many parties are affected.

II. TWO WAYS CORPORATIONS ARE TAXED: SUBCHAPTER C & SUBCHAPTER S



A. S Corporation versus C Corporation -- The Trends

The tax laws provide two alternative ways of taxing corporations. The general rule is that a corporation is subject to the corporate income tax under Subchapter C of the Internal Revenue Code ("C Corporation"). Sec. 11. There is another option available to a corporation that has fewer than 100 shareholders: it can file an election with the IRS to be taxed under Subchapter S of the Internal Revenue Code ("S Corporation"), provided that it meets the eligibility criteria. Secs. 1361 and 1362.

Except for three unusual situations, an S corporation does not pay income tax. Instead, the corporation's income is taxed directly to the shareholders. Sec. 1366. The principal advantage of this tax treatment is that a shareholder can avoid the double taxation of income that often occurs with a C corporation (the corporation=s income is first taxed and then dividends to shareholders of a Subchapter C corporation are taxed).

After the Tax Reform Act of 1986 made the taxation of S corporations more attractive than that of C corporations, small businesses embraced S corporations. Whereas only 24% of corporations were S corporations in 1986, by 2003 over 60% of corporations were S corporations. There are currently over 3.3 million S corporations and nearly 6 million shareholders. Luttrell, Kelly, "S Corporation Returns, 2003", *IRS Statistics of Income Bulletin*, Spring, 2006, pp. 91-165.

B. S Corporations B The Domain of Small Business

Assets Of S Corporations Based On Number Of Shareholders

Number of Shareholders	S Corporations Number	Percent	Average Assets Per Corporation ("Your mileage may vary")
All Corps	3,154,377	100%	$ 639,413 (Avg. Net Worth: $181,040)
1	1,809,402	57.0%	$ 347,127
2	937,771	30.0%	$ 445,904
3	178,185	6.0%	$ 1,058,112
4 to 10	192,241	6.0%	$ 2,274,870
11 to 20	15,758	0.5%	$ 8,850,616
Over 20	7,872	0.2%	$26,100,356

SOURCE: Luttrell, Kelly, *S Corporation Returns, 2002*, IRS Statistics of Income Bulletin, Spring, 2005, pp. 59-113, especially Table 1, Table 3, and Table 5.

III. CHARITABLE GIFTS OF STOCK

A. The Charity's Perspective on Gifts of Stock

Most charities prefer to sell contributed stock rather than hold it. First, they want to apply the proceeds -- or with an endowment, apply the investment income -- to charitable purposes. Second, a large block of donated stock will usually not conform to the charity's investment policy. The charity will prefer to diversify and put the proceeds in its investment pool.

This is easily accomplished with a gift of publicly traded stock that can be sold on the stock market. By comparison, stock of a closely-held business has an extremely limited market. The potential purchasers are usually limited to the corporation, the shareholders or a possible purchaser of the entire business. A common strategy has been for the shareholder to contribute closely-held stock with an informal understanding that the corporation will redeem the stock in the future. As long as the charity is not compelled to sell the stock to the corporation at the time of the gift, the IRS is agreeable with this arrangement. Rev. Rul. 78-197.

This arrangement had great appeal to shareholders. First, the ***shareholder*** was able to claim a charitable income tax deduction on his or her personal return for the gift of stock. Second, it was the ***corporation's cash*** that went to the charity to redeem the stock. This was a much better tax arrangement than if the corporation had paid a taxable dividend to the shareholder and the shareholder had given the cash to the charity. As a result, this gift-followed-by-redemption arrangement was a popular way for small business owners to make large charitable gifts.

B. Why Legislation Was Needed

What changed this paradigm of shareholder-gift-followed-by-redemption was the decline in the number of closely-held C corporations, many of which converted to S corporations. Between 1986 and 1993, the number of C corporations experienced an average annual decline of 3.2% whereas the number of S corporations grew at an annual rate of 13%. Even today, over 90,000 C corporations convert to Subchapter S status every year. Luttrell, Kelly, "S Corporation Returns, 2003", *IRS Statistics of Income Bulletin*, Spring, 2006, pp. 91-165, computed from Table 1 at p. 105.

This trend posed a challenge to charities, since the tax law prohibited them from owning stock of an S corporation. Until the law was changed, only individuals, estates and certain trusts were eligible to be shareholders. If an ineligible shareholder, such as a charity, ever acquired stock of an S corporation, the corporation lost its S corporation tax status and converted into a taxpaying Subchapter C corporation. Charities witnessed a major source of charitable gifts drying up as small business owners converted their corporations to Subchapter S status. They and others lobbied Congress to add charities to the list of eligible shareholders and their wish was granted: beginning in 1998, charities could own stock of S corporations. Sec. 1361(c)(6)

C. A Charity Can Be A Shareholder, But Not A Charitable Remainder Trust

With so many technical rules, it is easy to make a mistake that can have serious tax consequences. For example, whereas some forms of ***charitable lead trusts can*** own S corporation stock,[1] ***a charitable remainder trust cannot***.[2] When an ineligible shareholder acquires S corporation stock, the corporation loses its Subchapter S status and becomes a Subchapter C corporation.[3] The IRS has been very generous to forgive inadvertent mistakes and

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1 A charitable lead trust that is not a grantor trust can elect to be an Electing Small Business Trust ("ESBT"). Reg. Sec. 1.641(c)-1(k), Example (4).

2 A charitable remainder trust is not listed as an eligible shareholder in Secs. 1361(b)(1), 1361(c)(2) or 1361(c)(6), and, unlike a charitable lead trust, it is specifically prohibited from qualifying as an Electing Small Business Trust ("ESBT"). Sec. 1361(e)(1)(B)(iii). The Service also concluded in a revenue ruling that a charitable remainder trust could not qualify as a Qualified Subchapter S Trust ("QSST") under Sec. 1361(d). Rev. Rul. 92-48, 1992-26 I.R.B. 7.

3 Sec. 1362(d)(2)(A).

allow such transactions to be undone,[4] but obviously all parties would have been better served if the mistake had never been made in the first place.

D. Charity's Mistake -- To Structure S Corp Gifts Like the C Corp Gifts

Once the law was enacted, many charities approached small business owners ready to make the same shareholder-gift-followed-by-redemption transaction that had been popular with closely-held C corporations. What many people weren't aware of was that they could often accomplish better results by structuring the gift in a manner that had always been permitted: have the S corporation contribute some of its appreciated assets rather than have the shareholder contribute some of his or her stock.

Recall that the advantage of the shareholder-gift-followed-by-redemption strategy with a C corporation was that the *shareholder* obtained a charitable income tax deduction for the gift of stock even though the cash payment to the charity was ultimately made by the *corporation*. This two step process of gift-followed-by-redemption is not necessary for S corporation shareholders. Unlike a C corporation, an S corporation's financial transactions flow through to the shareholder's tax return. Thus, if an S corporation makes a simple cash gift to a charity, the charitable income tax deduction will be claimed on the *shareholder's tax return*. There is no need for the shareholder to contribute stock to obtain a charitable tax deduction when the corporation's gifts can produce these tax benefits to the shareholder, often at less cost since there is no need to pay to have the stock's value appraised. The charity also benefits from a gift by the corporation since it will not have to pay UBIT. By comparison, when a shareholder of the S corporation contributes stock, a charity has a UBIT liability for the income attributable to the days and/or years that it was a shareholder of an S corporation as well as a UBIT liability for the gain on the ultimate sale of the stock.

IV. THREE BAD THINGS HAPPEN WHEN S CORP STOCK IS DONATED TO A CHARITY

[4] Section 1362(f) provides that if the Secretary determines that there was an inadvertent termination of an S corporation, and if all affected parties work to restore S corporation status and make adjustments to income as if the corporation had never terminated, then, notwithstanding the terminating event, the corporation shall be treated as never having lost its S corporation status. The legislative history instructs the IRS to be liberal in granting waivers. S. Rep. No. 640, 97th Cong., 2d Sess. 12-13 (1982), 1982-2 C.B. 718, 723-24; H.R. Rep. No. 826, 97th Cong., 2d Sess. 12 (1982), 1982-2 C.B. 730, 735. As can be seen from the many waivers for transferring S corporation stock to IRAs, the IRS has been very generous in granting inadvertent termination relief.

By way of background, normally the best way to structure a large charitable gift is to contribute appreciated stock or real estate to a public charity. The donor gets the double tax benefit of an income tax deduction for the appreciated value of the property and also avoids recognizing the taxable gain that would have occurred had the property had been sold. Donors are aware of this and often make large gifts shortly before their corporation or real estate will be sold. However, the tax laws provide that three bad things happen when a donor contributes appreciated S corporation stock to a charity:

A. ***The donor's tax deduction is usually less than the appraised value of the stock.*** Congress made the tax deduction for a gift of S corporation stock comparable to a gift of a partnership interest rather than a gift of Subchapter C corporation stock. Consequently, a donor is required to reduce the deduction by the amount of *ordinary income* that the donor would recognize if the S corporation's assets were liquidated (that is, the portion of a hypothetical gain from selling inventory, assets subject to depreciation recapture, and other ordinary income assets). For most donors, this adjustment does not significantly affect the amount of the charitable tax deduction.

> The last sentence of section 170(e)(1) (relating to income tax charitable deductions for contributions of ordinary income and capital gain property) states: *"For purposes of applying this paragraph in the case of a charitable contribution of stock in an S corporation, rules similar to the rules of section 751 shall apply in determining whether gain on such stock would have been long-term capital gain if such stock were sold by the taxpayer*." Congress therefore imported the "hot asset" rules, which determine the amount of ordinary income versus capital gain that partners have when they sell their partnership interests, to charitable gifts of S corporation stock. By comparison, when a shareholder *sells* S corporation stock instead of contributing it to a charity, the partnership hot asset rules that apply to the sale of a partnership interest do not apply to the sale of stock. Instead, all of the gain is classified as capital gain. The partnership hot asset rules only apply to a charitable donation of S corporation stock and not a sale.

This may cause the corporation to pay more money to redeem the stock than the shareholder was able to deduct. For example, assume that a shareholder owns 100% of an S corporation and that the shareholder makes a charitable gift of stock that has an appraised value of $100,000. Also assume that the corporation holds $5,000 of ordinary income assets attributable to the stock, so that the charitable tax deduction for the stock gift would be reduced to $95,000. If the S corporation redeems the stock from the charity in an arms length transaction, the corporation would have to write a check for the entire appraised value of $100,000. The charity shouldn't sell the stock for anything less than its value. ***From a tax perspective, it would have been much better for the corporation to have simply made a cash gift of $100,000 to the charity.*** The full $100,000 charitable tax deduction would flow through to the shareholder's return, rather than just $95,000, and the parties would have avoided the costs of a qualified appraisal. Of course, if the shareholder's basis in the stock is very low -- for example, less than $100,000 -- then the corporate gift could produce less tax benefit to the donor than would a gift of stock.

B. ***For every day that the charity owns the stock, the charity must report its share of the corporation's income as unrelated business taxable income ("UBTI") and must pay the unrelated business income tax ("UBIT").*** The tax treatment is worse than a comparable gift of a partnership interest. A charity does not pay UBIT on its share of a partnership's passive investment income, such as interest or capital gains, but it will have to pay UBIT on such income earned by an S corporation. In 2003, nearly 20% of all S corporation income was from such investment sources.

> Sec. 512(e)(1) states: "If an organization described in section 1361(c)(6) [i.e., a charity or a Section 401(a) retirement plan] holds stock in an S corporation --
> (A) such interest shall be treated as an interest in an unrelated trade or business; and
> (B) notwithstanding any other provision of this part --
> (i) *all items of income*, loss, or deduction taken into account under section 1366(a) ... shall be taken into account in computing the unrelated business taxable income of such organization." (Emphasis added.)

C. ***Whereas normally a charity does not have UBTI when it sells stock from its investment portfolio for a profit, a sale of appreciated S corporation stock will trigger a UBIT liability***.

Normally an exempt organization excludes from the computation of UBTI any capital gains earned from the sale of corporate stock. Sec. 512(b)(6). However, with regard to the sale of S corporation stock, Sec. 512(e)(1)(B)(ii) overrides this exemption: "*notwithstanding any other provision of this part... any gain or loss on the disposition of the stock in the S corporation shall be taken into account in computing the unrelated business taxable income of such organization*."

In fact, the tax liability incurred by a charity can often be greater than the tax liability that the donor would have incurred had the donor sold the stock. Whereas individuals are subject to a maximum federal tax rate of only 15% on their long-term capital gains, incorporated charities receive no tax break for long-term capital gains and pay UBIT at ordinary corporate rates, which can be as high as 35%. Thus, if there is a $100,000 gain, the shareholder would have paid only $15,000 federal tax on the sale but the charity that receives the stock as a gift must pay a tax as high as $35,000! By comparison, a charity that is a trust rather than a corporation can pay the same low 15% rate as the donor.

V. THE BEST WAY TO STRUCTURE A CHARITABLE GIFT

A. Overview

Despite these three negative consequences, an optimist will observe that charitable gifts by S corporations and their shareholders can be structured in a multitude of ways that isn't possible in many business settings. This is because in most cases an S corporation is owned by just one or two shareholders who absolutely dominate every aspect of the business' operations. Thus the parties can select the best possible asset for a charitable gift, whether it is the shareholder's stock or specific assets owned by the corporation. They can also select the best charitable beneficiary.

What are the best ways for a shareholder of an S corporation to structure a charitable gift? The answer depends on many factors, including whether the corporation will continue as a going concern or if the gift is made in contemplation of an imminent sale of the business or the death of the controlling shareholder.

In most cases both the donor and the charity will usually benefit if the corporation contributes some of its assets rather than if the shareholder contributes stock. With either type of gift, the tax benefit will be claimed by the <u>shareholder</u>. Either the shareholder will deduct the shareholder's gift of stock or the shareholder will deduct the corporation's gift, since an S corporation's financial transactions flow through to the shareholder's personal return. The principal advantage from having the S corporation make the charitable gift is that the three negatives described above will not apply. The donor's income tax deduction will not be reduced and the charity will usually not pay UBIT when it owns or sells a gift received from a corporation.

The tax planner should therefor first explore whether such a gift is possible. Does the corporation have cash or appreciated property that it could contribute to a charity? In many cases the corporation might not have any assets that are suitable for a charitable gift so that a shareholder's gift of stock may be the only viable option.

B. Advantages of Gift By Corporation – In General

1. *A charitable deduction for a gift of corporate property (e.g., real estate) would not be reduced by a lack of marketability discount as a shareholder's gift of stock would be*. That is, the corporation's real estate could be valued at its full worth, but the stock of any closely held business will often be appraised at less than the value of the corporation's underlying assets because of the difficulty of selling a minority interest in a closely held business.

2. As was explained above, the charitable income tax deduction for a gift of corporate property is not reduced by the value of any other assets that the S corporation owns, whereas *the income tax deduction for a charitable gift of S corporation stock will usually be less than the appraised value to reflect any "ordinary income" assets that the S corporation might have*.

3. *A charitable gift of property can avoid the "built-in gains tax" of Section 1374.* When a Subchapter C corporation converts to a Subchapter S corporation, a special tax is triggered if the corporation disposes of any appreciated property that it owned on the date of conversion -- whether by sale or distribution to the shareholders -- within ten years of the conversion date. Such a disposition will usually trigger both a taxable gain to the shareholders under the Subchapter S rules and a Sec. 1374 income tax liability to the corporation based on the value of the property on the conversion date. The built-in gains tax is by far the most frequent and largest of the three corporate taxes that S corporations pay. Therefore, it was a significant development

when the IRS concluded in a private letter ruling that no such tax would be triggered by an outright charitable gift of such property within ten years of the conversion date. Private Letter Ruling 200004032 (Jan 28, 2000). There is no comparable IRS pronouncement on the consequences of a deferred charitable gift of such property, such as a contribution to a charitable remainder trust.

4. A charity is not subject to UBIT on the income of the contributed property such as real estate (unless it was "debt-financed") or on the gain from its sale, whereas *a charity will have to pay UBIT taxes when it holds and sells stock of a profitable S corporation* and

5. *Although a **charitable remainder trust** ("CRT") cannot receive or hold S corporation stock, it can receive and hold corporate assets, such as real estate.* Such a CRT is usually for a term of years (e.g., 20 years) rather than for the life of an individual.

Both the corporation and shareholder could benefit by having the corporation contribute real estate or other appreciated property to a CRT and then having the CRT sell the real estate. First, the charitable income tax deduction from the gift of real estate would flow through to the shareholder's individual returns. Second, since a CRT is tax-exempt, it will not pay any tax on the gain when it sells the real estate. It can thereby retain greater cash that can be invested to produce greater annual cash flow to benefit the S corporation, which the S corporation can then distribute to the shareholder. In over simplified terms, the charitable remainder trust would issue a check payable to the corporation and the corporation would simply endorse the check to the shareholder. The income from the charitable remainder trust would be reported on the S corporation's return and, in turn, would then appear on the shareholder's personal tax return.

There are three important situations when the S corporation laws can cause problems for a corporate gift to a charitable remainder trust. First, it is important that the term of the charitable remainder trust be a fixed number of years rather than a term measured by the life of a shareholder. According to one private letter ruling, it could be an income tax disaster if an S corporation establishes a charitable remainder trust that will last for the life of a shareholder. Private Letter Ruling 200203034 (Oct. 18, 2001). Second, as was explained above, there is no guidance from the IRS about the impact of a contribution of property that might be subject to the Sec. 1374 built-in gains tax. Perhaps the tax would be triggered; perhaps not. Finally, under certain circumstances -- most likely when the corporation liquidates its assets -- the investment income from the charitable remainder trust could trigger a corporate tax and could cause the corporation to involuntarily convert from a Subchapter S corporation to a Subchapter C corporation. Sec. 1375 and Sec. 1362(d)(3).

C. 2006 & 2007 -New Incentive for S Corporations To Donate Appreciated Property

In 2006 and 2007, charitable gifts by S corporations will qualify for the same favorable income tax treatment that currently applies to such charitable gifts made by partnerships and limited liability companies (ALLCs@). Until this law was enacted, such gifts by S corporations were subject to a comparable tax disadvantage. Normally the prime situation for obtaining a tax benefit from a charitable gift of appreciated property is to make the gift shortly before its sale, but this strategy does not work well with a gift of S corporation assets. Rather than incur the cost of an appraisal for a gift of appreciated property, it may be easier for the corporation to sell its assets and then make a cash gift.

EXAMPLE: Assume that an S corporation with only one shareholder is about to sell all of its assets. ***The corporation has $1 million of assets with a cost basis of $400,000, which if sold would produce a $600,000 gain.*** Assume that the shareholder's stock has the same numbers: $1 million value and $400,000 basis. If the corporation sold all of its assets and the gain was taxed to the shareholder, the basis in the stock would increase to $1 million ($400,000 + $600,000 taxable gain). Thus, when the corporation distributes the $1 million cash proceeds to the shareholder in liquidation, the shareholder would not recognize a gain upon liquidation. The shareholder could then make a charitable cash gift of $100,000 and claim a $100,000 charitable income tax deduction. End result: $600,000 taxable gain and $100,000 charitable tax deduction.

Charitable Gift Under Prior Law: Rather than sell all of its assets, the corporation might make a charitable contribution of some of its appreciated property before the anticipated sale. Among the corporation's assets is appreciated real estate with a value of $100,000 and a cost basis of $20,000. To claim a charitable tax deduction for a gift of the real estate, the corporation would have to pay for a qualified appraisal. If the corporation donates the real estate to a charity before the sale, the shareholder could deduct a $100,000 charitable gift but has to reduce her basis in her stock by the full $100,000 -- from $400,000 to $300,000. When the corporation sells the remainder of its assets for $900,000, the corporation will recognize a gain of $520,000 ($900,000 sale price minus the remaining $380,000 basis that the corporation has in its assets).

The problem was that when the corporation liquidates and distributes the $900,000 cash to the shareholder, the shareholder will have to recognize a taxable gain of $80,000. This is because the shareholder's stock basis is only $820,000 (original $400,000 minus $100,000 charitable deduction plus $520,000 taxable gain). ***Thus, the shareholder will ultimately recognize the same $600,000 taxable gain*** ($520,000 when corporation sells assets plus $80,000 on liquidation) that the shareholder would have recognized had there been no charitable gift of property at all. It would be simpler to sell the assets and give cash. By comparison, if a partnership or a LLC made the same gift, the owner's basis in the partnership interest or LLC interest would be reduced only by the $20,000 cost basis rather than the appreciated $100,000 market value and there would indeed be a tax advantage to a gift of appreciated property before its sale.

New Law For 2006 and 2007: The S corporation would have parallel treatment: the shareholder=s basis in the stock is only by the $20,000 cost basis rather than the appreciated $100,000 market value and there would indeed be a tax advantage to a gift of appreciated property before its sale. ***The shareholder would only recognize a $520,000 gain when the remaining assets are sold.***

> The following sentence was added at the end of Sec. 1367(a) : A The decrease under Subparagraph(B) by reason of a charitable contribution ... of property shall be the amount equal to the shareholder=s pro rata share of the adjusted basis of such property. The preceding sentence shall not apply to contributions made in taxable years beginning in December 31, 2007.@ [As amended by Sec. 1203 of the Pension Protection Act of 2006]

Special Appeal: Charitable Gift by S Corporation With Built-in Gains Tax (ASec. 1374") Property. When a Subchapter C corporation converts to a Subchapter S corporation, a special tax is triggered if the corporation disposes of any appreciated property that it owned on the date of conversion -- whether by sale or distribution to the shareholders -- within ten years of the conversion date. Such a disposition will usually trigger both a taxable gain to the shareholders under the Subchapter S rules and a Sec. 1374 income tax liability to the corporation based on the value of the property on the conversion date. The built-in gains tax is by far the most frequent and largest of the three corporate taxes that S corporations pay. Therefore, it was a significant development when the IRS concluded in a private letter ruling that no such tax would be triggered by an outright charitable gift of such property within ten years of the conversion date. Private Letter Ruling 200004032 (Jan 28, 2000). There is no comparable IRS pronouncement on the consequences of a deferred charitable gift of such property, such as a contribution to a charitable remainder trust.

D. Obstacles For Corporate Charitable Gifts.

There are several complications that could prevent a corporation from making a charitable gift of its assets or prevent a shareholder from claiming income tax deductions for the corporation's gift. In that case a shareholder's gift of stock might be the primary charitable giving opportunity. These obstacles include:

1. If there are *other shareholders* who do not want to make a charitable gift to a particular charity, the shareholder who is advocating a charitable gift might be limited to giving her or his stock. One solution when there are shareholders with diverse charitable interests is for the corporation to establish a corporate *donor advised fund*. A donor advised fund is a grant-making account at a community foundation, Jewish federation, national donor advised fund or other sponsoring organization where donors recommend grants from the fund to other public charities. The corporation's donor advised fund can be divided into sub-accounts that will allow each shareholder to recommend grants to the public charities that each shareholder wants to support.

2. *The S corporation might not have any assets that are attractive to the charity* (e.g., the only assets are equipment and inventory) so that stock will be the main option.

3. *The charitable income tax deduction could be limited for shareholders who have a low tax basis in their S corporation stock.* For example, if an S corporation informs a shareholder that her deduction for the corporation's charitable gifts is $20,000, but the shareholder only has stock with a basis of $12,000, the shareholder will be limited to a $12,000 deduction that year. If a shareholder has a very low basis in his or her stock, then a gift of the stock may be the only way for the shareholder to get a charitable tax benefit. With nearly one third of S corporations reporting operating losses, it is very common for a shareholder to have a low basis in his or her stock.

4. *If an S Corporation donates "substantially all" of its assets to a charity, the corporation will be treated as if it had liquidated. This will trigger an income tax liability as if the corporation had sold its assets to an unrelated buyer.*

The definition of what constitutes "substantially all" isn't clear. Contributing 80% or more of its assets to charity will probably trigger the liability. Some people are concerned that contributing just a majority of the assets (over 50%) may be enough to cause problems. Consequently, the most generous gift that a shareholder can make -- a gift or bequest of the entire corporation -- poses serious tax challenges to a charity. When the S corporation distributes assets to the charitable parent corporation -- even assets that could be considered charitable, such as a valuable painting that the charity will display to the public -- the S corporation will recognize a taxable gain on the distribution as if the asset had been sold to a buyer and there will be no offsetting charitable income tax deduction[5].

5. Although an accrual-method corporation can usually deduct a charitable pledge in the year it makes the pledge as long as it pays the pledge within the first 2 2 months of the next year, *cash-method shareholders of S corporations will not be able to deduct an S corporation's charitable gifts until the corporation actually makes the gift*.

[5] Sec. 1371(a) provides that an S corporation is subject to the same tax laws as a C corporation unless there is a specific S corporation law that is in conflict. Generally, a C corporation that distributes appreciated property to shareholder must recognize a taxable gain as if the property had been sold, whether the distribution is made by an ongoing corporation (Sec. 311(b)(1)) or in liquidation (Sec. 336(a)).

VI. CHECKLIST FOR A CHARITY WHEN IT IS OFFERED A GIFT OF S CORPORATION STOCK

A. Charitable Purpose. If donor intends to make a restricted gift (e.g., scholarships only, endowment only), are the donor's charitable purposes acceptable?

B. Stock As An Investment

1. What is the nature of the business and its prospects for profitability?
2. What is the stock worth?
3. When will the charity likely sell it?
4. During the time that the charity will own the stock, what is the expected after-tax cash flow from the stock? The after-tax cash flow will be the cash distributions from the S corporation minus the UBIT.

C. Should Donor's Recognition or Benefits be Adjusted for Anticipated UBIT?

1. Should donor get credit in a major campaign for the full appraised value of the stock or only for the anticipated net amount after UBIT?
2. If a charitable gift annuity will be issued, should the payments be reduced since there will be less cash after the stock's sale because of the UBIT?

D. State Law Issues.

1. Can charity own stock under state law?
2. Is there a state UBIT?

E. UBIT Concerns

1. Will gift be made to a charitable trust or an incorporated charity? If a charity has a choice, determine which type of entity will pay the least amount of UBIT.
2. What is donor's adjusted tax basis in the stock? If donor does not know, the basis might be estimated by looking at the balance sheet of the corporation's income tax return.

   Donor's tax basis is important because it:

   -- Affects the gain or loss upon the sale of stock.
   -- Affects whether cash distributions from S corporation are taxable or tax-free.
   -- Affects whether an S corporation's losses will be deductible or not.

3. What is the projected taxable income or losses of the corporation? How much UBIT will the charity have to pay while it holds the stock? Examine the Schedule K-1 that the donor received from the S corporation.

4. What are the projected cash and property distributions to the charity? See Line 20 of Schedule K-1.

   <u>Cash distributions?</u>

      Expected Amounts?

         Sufficient to pay UBIT? Any extra for charitable purposes?

      Distributions taxable or tax free?

      Timing of distributions to meet quarterly UBIT payments when due?

   <u>Property distributions?</u>

      A distribution of appreciated property could trigger tax. Are any such distributions planned in the near future?

5. Will charity have to file UBIT Form 990-T return (required if gross UBTI is over $1,000)?
6. Will charity have to make quarterly UBIT estimated tax payments (required if tax due for any year over $500)?

F. <u>Administrative Requirements If Gift Is Accepted.</u>

1. Charity must sign donor's Form 8283 ("qualified appraisal") to acknowledge receipt of gift of stock. The donor should be aware that unlike gifts of other kinds of stock, the tax deduction for a gift of S corporation will often be less than the appraised value of the stock.
2. Charity should send donor a "contemporaneous written acknowledgment" that contains the language necessary for the donor to claim a charitable income tax deduction.

G. <u>Sale of Stock</u>

1. Obtain evidence that the stock is being sold for its fair value (e.g., a recent appraisal).
2. Send Form 8282 to the IRS and to the donor if property is sold within two years of receipt.
3. Charity must pay UBIT on the gain from the sale of S corporation stock.

OTHER ISSUES

A. When are cash and property distributions taxed as UBIT?
B. Low basis of S corporation stock can cause problems
C. Tax issues for S corporation with losses
D. Is municipal bond interest subject to UBIT?
E. Can an S corporation's charitable contributions reduce UBIT?
F. Does S corporation income keep or lose its character for UBIT?
G. What if charity and S corporation have different fiscal years?
H. Tax issues if S corporation was once a C corporation
I. Private foundation as an S corporation shareholder
J. Inadvertent termination of S corporation status
K. What happens if, while a charity owns stock, an S corporation switches to be a C corporation, or vice-versa?
L. Does the installment sales method apply when a charity sells its S corporation stock in exchange for the buyer's promissory note?

GIFTS FROM SUBCHAPTER S CORPORATIONS & THEIR SHAREHOLDERS

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Atlanta, Georgia

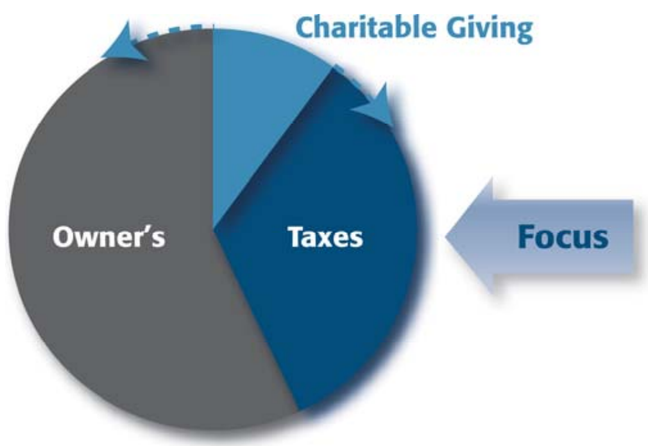
I. A Significant Opportunity for your Non-Profit: Gifts of appreciated Sub Chapter S stock and other closely held business entities can be a significant funding opportunity for your Non Profit organization. Generally the gifts are larger gifts, offer the donor greater tax benefits and savings and can move more resources to projects and missions that the donor believes in.

A. Giving Statistics: In 2005, an average of 2.2% of disposable income was given per U.S. household to charity. (From Giving USA 2006 report). Almost 80% of the time, the source of charitable gifts were made from current income/cash. Although gifts of appreciated wealth offer far greater benefits for the donor and greater results for the charity, most often donors think in terms of “checkbook” giving. Writing a check is convenient, and therefore many charities focus primarily on the cash donation, however, this is often the most costly gift for the donor and the smallest gift for the charity.

B. The Balance Sheet – Cash or close to cash assets represent only a small portion (7%) of a donor’s total wealth, the majority of charitable giving comes from this smaller class on the balance sheet. Why might this be so? Donors do not often consider giving to charity from other assets. They may not clearly understand the tax benefits and they may not have financial or legal counsel that brings awareness to and educates them in the advantages. Charities do not often ask for gifts from other assets because the process is lengthy, the legal and tax implications can be confusing and the charity does not have a process to identify and pursue other asset gifts.

*This percentage has been deduced from numbers in *Giving USA 2005* and IRS statistics.
**See *Estate Tax Returns Filed in 2003: Gross Estate by Type of Property, Deductions, Taxable Estate, Estate Tax and Tax Credits, by Size of Gross Estate* (available at http://www.irs.gov).

There exists an incredible but missed opportunity. In a survey of tax returns from 2001, it was noted that an additional $700,000,000 could have been donated to charity had donors replaced cash donations with long-term appreciated assets which they sold in the same year with a taxable gain. With greater education, a change in charities approach to securing donations, and organizing a wise and efficient process, charities will have the ability to secure greater funding often without any reduction in the donors personal expenditures.



C. What can your non profit do? First, educate and inform your donors about the non cash giving opportunity. This may be done via seminars, donor stories in marketing materials or one on one with development staff. Secondly, train gift development staff to readily identify opportunities for donors to give from wealth. Finally, design a program to review and analyze non cash gifts, thereby facilitating receipt management and sale of appreciated asset gifts. The process of planning, due diligence and administration can be complex, so it may be more advantageous to seek a third party vendor who can provide a team of experts. Either way your non profit organization can be the benefactor of greater resources and your donor can enjoy the benefits of making a greater impact with their giving.

D. A word about Training: Train your team to spot an opportunity for a gift of an S Corporation ownership interest. There are various conversational triggers which can identify an opportunity to talk with your donor about giving from wealth. The following are examples of events or ideas which may be explored for a potential gift of appreciated property.

- A donor mentions that he is thinking about retirement and knows that it may be time to consider selling out of the business.
- A donor's lifestyle you notice is below their annual income.
- You understand that they plan to give at death to charity.
- A donor in selling an investment property.
- A donor may be passing a family business or investment to the next generation.

After an opportunity is identified, benefits of giving in like kind may be shared with the donor in a general fashion. A worksheet which illustrates in general the tax savings and final personal financial benefit may be helpful for the donor to visualize the impact. It is also timely to engage the donor's financial, tax and legal counsel.

II. Gift Planning Due Diligence – Discussions with your donor: When the donor has identified an opportunity to give from wealth by making a contribution from his Sub Chapter S stock or assets, there are multiple areas in which you may provide guidance to the donor and his advisory counsel.

A. Tax Matters: The following questions should be reviewed with the donor in concert with his tax counsel in order to structure the most advantageous gift:

- What is the donor's tax basis in his stock? What is the basis in the asset within the S Corporation if an asset gift is contemplated?
- Are there other shareholders and who are they?
- Will the donor make use of the deduction with a 5 year carry forward and the ability to offset the donation value against 30% of adjusted gross income?
- Is the asset considered long term capital gain property (over 1 year) otherwise if held less than one year, the donor will receive a basis deduction?
- What are the activities of the corporation?
- What is the historical annual income from operations?
- What are the quarterly distributions to shareholders?

B. Appraisals: The donor is responsible for obtaining an independent qualified appraisal of the gifted asset to support his deduction. (see IRS Publication 561 for summary of appraisal guidelines). You may want to provide a complimentary copy of the guidelines for your donor. Let him know that discounts for minority interests or lack of marketability may be applied to the final appraised value. Also, in the case of gifts of Sub Chapter S Corporation stock, the deduction value is reduced by the ordinary income component. The deduction is not necessary the same as the selling price of the asset. Also, inform your donor that the selling price of the gifted asset is reported to the IRS should the charity sell the gifted asset within 3 years of the gift date by using form 8282. Form 8282 should be filed by the charity within 125 days after the sale. Recently with HR 4, penalties for overvaluation have increased. It is important that your donor be aware of the application of these rules.

C. Timing and avoiding a prearranged sale: Often the presence of a possible buyer is the catalyst for the donors interest in making this gift, therefore, the gift must be reviewed and asset due diligence completed within a short time window. The gift must be completed (the stock or asset transferred to the charity) prior to execution of a sale contract in order to avoid a prearranged sale. This places pressure on the charity to be nimble or else face loosing the gift. Having a team of experts at hand, ready with appropriate analysis tools and templates for transfer is important.

D. Dealing with uncertainty: The donor or his advisors may express concern with the non profit organization joining the other shareholders as a shareholder. Advisors may be concerned that the S election might be lost at gift or at sale, should the non profit sell it shares to multiple parties and raising the number of shareholders beyond the requirement. A well drafted shareholders agreement can be drafted which would restrict the shares for all shareholders including the non profit, from being sold without consent of other owners.

E. If the shares are voting, the donor may consider a reorganization to establish a voting and nonvoting class, convert a portion of his shares to nonvoting and make the charitable gift from the non voting class.

F. Illustrating and emphasizing the benefit: An illustration or chart comparing the tax results of the donor selling the property himself versus giving the asset or stock to charity prior to sale, can be a powerful tool to emphasize the benefits for the donor and charity.

Stock Gift: Assuming the charity has a trust established for the receipt of Sub Chapter S corporation shares and the trust maximizes its 50% adjusted gross income deduction, the gains tax may be reduced in half, in effect lowering the rate from 15% to 7.5%. If the trust is organized and operates in a state without state income tax, there may also be a state gain tax savings. The donor avoids personally paying the gains tax on the sale and also receives the benefit of the fair market value deduction (less any S Corporation reduction).

Asset Gift: The donor’s illustration will show the gains tax savings for the donor and the charity and the fair market value deduction for the donor. See sample illustration page 11

G. Motivation and Charitable Intent: It is a good idea to establish charitable intent early on as you work with your donor and to formalize this within the language of the gift agreement or charitable transfer and assignment.

H. Strategies to suit the donor's needs: What is the best charitable vehicle to accomplish the donor's objectives? – If you discover that the client has an income need, you may explore the idea of giving assets from the corporation to a charitable remainder trust. If there is more than one owner, the gift of an asset may not be possible; therefore a gift of Sub chapter S stock in exchange for a charitable gift annuity may be the best opportunity.

I. Donor's advisory team: Get the donor's full advisory team on board early on. The team of experts from the charity should connect directly with the donors counsel to discuss the potential gift and the tax/legal implications of the gift. The charity's team of experts may need to be the ones to provide the legal basis for how this can work and why it works. Seek to support the donor's advisors and refrain from conflict with the donor's advisor team in front of the donor. The advisors may not always been in full support of the charity's recommendations, however, the charity's professionalism and knowledge may impress the advisors such that they refer other clients in the future.

J. Current gifts versus testamentary gifts: Remember that charitable contributions at death do not enjoy an income tax deduction (only an estate tax deduction). Therefore, if the donor does not need the asset for retirement income, it may be better to contribute during life, so that they enjoy the tax deduction.

K. Single transaction opportunity and using a third party intermediary: A single transaction opportunity may blossom into multiple opportunities. As an example, if there are other shareholders, inquire if they may also be open to tax savings and making a charitable gift. Many will be and you can serve as facilitator of the process creating an opportunity to receive additional funding for the charity. The use of a donor advised fund as a third party intermediary may serve in this capacity. Also, if the S corporation is making a gift of an asset and the S corporation has multiple shareholders, the donor advised fund can be used to receive the gift of the asset from the S corporation. The donor advised fund can be allocated between the various shareholders. Each shareholder receives his pass thru deduction and each receives grant advisory privileges over the proceeds of sale. Your donor can further direct his gift to your charity and still accomplish his objectives.

III. Asset Due Diligence - Protecting Your Non Profit: The charity should evaluate the gift for the impact, positive or negative that it may have on the charity. A proper evaluation begins with requesting and reviewing basic organizational documents and financial documents.

A. The following documents will provide a basis for asset due diligence.

- Articles of Incorporation and amendments
- Current By Laws
- Number of Authorized shares and class and listing of shareholders
- Shareholder's agreement with amendments
- Audited Financial Statements to include Balance Sheet and Corp. tax return

- Current Valuation and adjusted tax basis
- Historical K-1's

B. The charity's legal and tax team will use these documents to review the asset for the following:

1. Transferability – The shareholders agreement will give insight into the shareholders rights and obligations as well as any necessary waivers and consents for transfer. The completion of the consents will be necessary to open up a window for the donor to complete their gift.
2. Restrictions and responsibilities of ownership – The charity should understand their duties and responsibilities as a shareholder. As a sale is agreed upon, the charity should review the sale contract. Often the buyer will ask that all shareholders make representations and warranties about the state of the corporation. Generally, it is not advisable for the charity to make these representations as they are unfamiliar with the corporation. The charity should ask for a waiver from these representations. If the charity is a majority shareholder, this waiver may be more difficult to obtain.
3. Marketability of the shares – Is the charity willing to hold the asset and bear the responsibility of any ongoing management obligations. Is the annual distribution to shareholders sufficient to cover unrelated business income tax due? If the shares are held for income, will there be any funds left over after taxes to conduct charitable work or must the charity wait until there is a sale?
4. Financial obligations and managing liquidity needs -
   - Income from operations vs distributions: Reviewing previous years K-1s can give insight into the historical flow of funds to shareholders. What is the financial health of the company? Are earnings primarily invested back into the company or do they distribute earnings to shareholders? Is a request for an annual distribution requirements of value to the charity?
   - Gain on sale: The charity will need to understand the details of the sale and the donors basis in order to evaluate their UBTI obligation. Caution should be taken to set aside a generous amount of funds from sale until the final calculation is made and the tax return submitted and approved by the IRS.

IV. Planning Scenarios for Sub Chapter S gifts:

A. Programming with Giving in Mind - Art and Barbara Wright launched a very successful software development business in the mid 1990's. By 2000, the business was generating profits of nearly $2 million per year. That's the good news. The bad news is that they had to report all of this income on their IRS form 990 since the couple were the sole shareholders of the S Corporation. Their annual income tax liability was about $650,000! In conversations with their financial planner, they inquired if there was a way for them to divert some of the income they paid in taxes instead to the charities they wanted to support. Together with their advisors and NCF gift planners, a plan was devised to meet their objectives which were noted as:

- Build a plan to lower the current income taxes
- Increase charitable giving supported through tax dollars.
- Allow ownership interests in the company to be sold to employees.
- Begin to transfer ownership of the company to children who work in the family business.

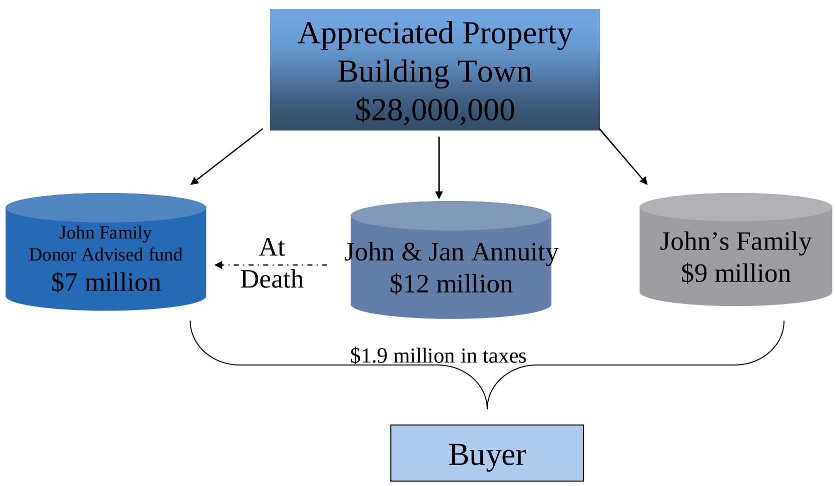
Art and Barbara enacted a plan to transfer a non-controlling interest in their business worth $3,000,000 to their donor advised fund. Their deduction provided a 30% reduction in their current income taxes by lowering their tax bill by approximately $600,000 for 5 years. The shares were held in the donor advised fund which received its proportionate share of income from operations. Overtime, the shares were sold to employees and family members. This resulted in additional funds for Art and Barbara to give to their favorite charities.

B. Double Take – John and George began Building Town in the mid 1970's. George ran the operational side of the business and John focused on generating new business. The solid partnership saw the S corporation grow to a $70 million business operating in 5 mid western states. The partners and their families lived a modest lifestyle over the years and had invested most of the profits back into the business. In recent years, John made contact with a company similar to their business and explored in conversation and opportunity to merge the businesses. John recognized an opportunity to start planning an exit strategy and wanted to do this in a wise and tax efficient manner. John and George, their legal advisors, and NCF mapped out a plan to fulfill their objectives which were noted as:

- Control the sale of the business for optimum price with the flexibility to receive a combination cash & stock sale and participation in an "earn out" arrangement.
- Income
- Each family to place approximately 40% of stock in a Charitable Gift annuity
- Retain approx 30 % of the stock for personal use.
- Give 30% to the fifty plus charities that they desire to support over time using a donor advised fund.

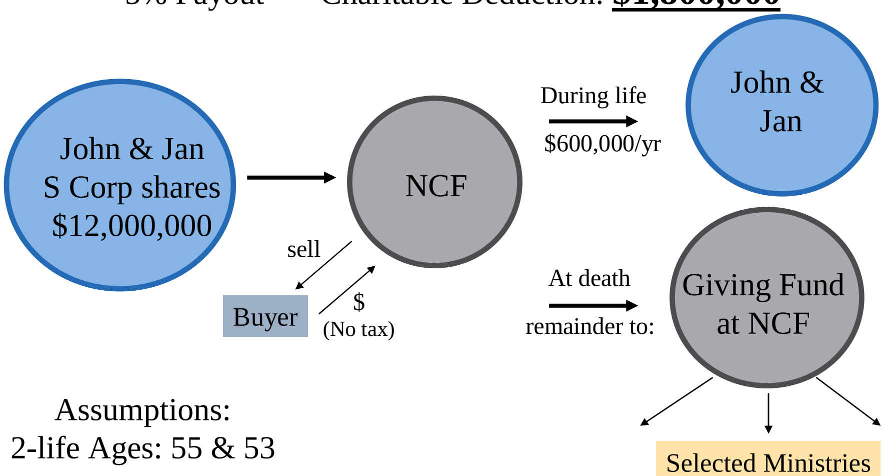
The gift arrangements were completed and the proposed sale of the stock took place 8 months later which allowed John and George to continue to work in the business. Avoiding state gains tax and reducing in half, the federal gains tax on 70% of the asset, allowed the partners to save over $4 million in tax dollars. Instead the families allocated this to the charities they support. After the two year deferral, the partners began to receive a regular income stream which will continue for life. The donor advised fund owns a small position in the new company which is also proving to be very successful.

Illustration: Showing the Allocation of Appreciated Property Interest Prior to Sale



Charitable Gift Annuity

5% Payout Charitable Deduction: **<u>$1,800,000</u>**



Assumptions:
2-life Ages: 55 & 53

S Corporation Stock
Comparison Illustration: Advantages of Gifting Before Selling

ASSUMPTIONS		
Fair Market Value of S Corp stock	$	3,000,000
Basis of S Corp Stock	$	-
Federal Income Tax Rate - Ordinary Income		35.0%
Federal Income Tax Rate - Capital Gains		15%
State Income Tax Rate		6%
Donor can use all deductions in the current year (30% or 50%)		

Comparison of Taxes: Gifting Before Selling	Donate S Corp Stock to Charity	Net Tax Savings		Sell S Corp Stock 1st, then Donate Cash	Net Tax Savings		Advantage to Donor
Gain							
S Corp Stock	0			3,000,000			
Less, Basis in S Corp Stock	0			0			
Taxable Gain	$0			$3,000,000			
Taxes Paid on Gain from Sale							
Federal	0			(450,000)			
State	0			(180,000)			
Total Federal & State Taxes Paid		$0			($630,000)		
Donation to Charity	$3,000,000			$2,370,000			
Tax Savings from Charitable Deduction							
Federal	1,050,000			829,500			
State	180,000			142,200			
Total Federal & State Taxes Saved due to Charitable Deduction		$1,230,000	(1)		$971,700		
* Note: charitable deduction may be reduced by ordinary income component							
NET Tax Savings		$1,230,000	(1)		$341,700	(2)	**$888,300**

Amount Available for Charitable Giving				
Taxable Income for Charity				
FMV of S Corp Stock Received		$ 3,000,000	$0	
Less, Basis in S Corp Stock		0	0	
Taxable Gain Before Charitable Deduction		3,000,000	0	
Charitable Tax Deduction		(1,500,000)	0	
Taxable Income After Charitable Deduction		$1,500,000	$0	
Taxes Paid				
Federal		225,000	0	
State - Texas (no SIT due)		0		
Total Federal & State Taxes Paid		$225,000	$0	
Amount Available for Charitable Giving				
Charitable Donation - Cash			2,370,000	
Stock Sale		3,000,000	0	
Less, Taxes Paid	(0.075)	(225,000)	0	
Net Amount Available for Charitable Giving		$2,775,000	$2,370,000	**$405,000**

SUMMARY OF ADVANTAGES FOR THIS ILLUSTRATION

	Donate	Sell & then Donate Proceeds *(net of taxes)*	Advantages of Gifting Before Selling	
Charitable Deduction	$3,000,000	$2,370,000	$630,000	Larger charitable deduction.
Tax Savings	1,230,000 (1)	341,700 (2)	$888,300	More taxes saved, **personally**.
Funds Available to Give	$2,775,000 (3)	$2,370,000	$405,000	More available for charitable giving.

Notes:

(1) A $300,000 charitable deduction in the 35% federal tax and 6% state tax bracket will save $1,230,000 , if you are able to use the full deduction. The charitable deduction will be limited to 30% of Adjusted Gross Income.

(2) If you sell the stock, and then donate the proceeds, net of tax, taxes saved will be $341,700 because the tax cost to sell the stock and the tax savings from the donation are netted together.

(3) If the charitable trust sells the stock the tax liability is generally less if the trust is organized and operates in a state with no state income tax. Operations of the S Corporation and the state(s) in which the shareholders live and business operations are conducted may have an impact on which states may levy state tax on ordinary income or gain income. .