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Six Ways to Use CRTS with Small Business Owners

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6 WAYS TO USE CRTS WITH SMALL BUSINESS OWNERS

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Common Considerations When Planning For Business Owners

Business Form

Business entities come in many forms. Often, donors are unclear as to the actual business form under which their business is operating. In order to determine the actual form of the business entity, one should examine the organizing documents of the business and the tax form filed. See Table 1 for a listing of the associated organizing documents and tax forms for each business entity form.[1]

Table 1

Business Entity Forms	Organizing Documents	Tax Forms Filed
C-Corporation	Articles of Incorporation, By-laws	Federal Form 1120
S-Corporation	Articles of Incorporation, By-laws	Federal Form 1120-S
Partnership	Partnership Agreement	Federal Form 1065
Limited Liability Company (LLC)	Articles of Organization, By-laws	Federal Form 1065[2]

Understanding the business form is important to determine:

- What the donor can actually contribute to a charitable remainder trust (CRT);
- The procedure that will be required to correctly transfer ownership;
- Whether the approval of others is required;
- The nature of the valuation that will be required to substantiate a charitable deduction; and
- The applicability of various valuation discounts.

Planning Pointer

It is common for donors to fail to understand the nuances of property ownership. For example, it is common for financial and legal advisors to recommend that real property be owned inside of a business structure or that a family business be held in a trust. Often, the existence of these poorly-understood legal structures has little bearing on day-to-day management and ownership decisions—further masking the technical issues involved in making a contribution to a CRT. As a result, the gift planner may be required to dig deeper to ascertain whether a business or property is owned outright, through a family trust, or one of the business forms described above.

[1] The treatment of Professional Corporations, Professional Partnerships, Professional Limited Liability Companies, Personal Holding Companies, Business Trusts, and similar entities is beyond the scope of this paper.

[2] Under Treas. Reg. §301.7701, et seq., a limited liability company is permitted to elect to be taxed as a partnership or corporation. If an LLC elects to be taxed as a corporation, it may further elect to be taxed as an S-corporation. If the LLC has elected to be taxed under either corporate form, then it will file the Federal form associated with the corporate form elected.

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Planning Pointer

The vast majority of LLCs elect to be taxed as a partnership for income tax purposes.[3] Unless specifically noted, references to partnerships apply equally to general partnerships, limited partnerships (including family limited partnerships), and LLCs. In practice, LLCs may also elect to be taxed as C-corporations or S-corporations. Therefore, care should be exercised to determine the tax status of any entity that is the subject of a CRT plan.

Ownership Transfer

A charitable contribution deduction is allowed in the year in which a charitable contribution is made.[4] A charitable contribution is complete when the donor relinquishes dominion and control over the contributed asset.[5]

In order to relinquish dominion and control over a contributed asset, the donor must observe the legal formalities of transferring title. The legal formalities to be observed will vary according to the asset being transferred and the rules of the applicable jurisdiction. However, properly following the prescribed procedures will establish the date of the contribution, ensure that the gift is respected, and reduce complications upon subsequent sale of the contributed asset.

Limitations on the ability to transfer title to property in the business entity context may come from a number of sources. The entity's governing documents, state law, and other relevant materials should be reviewed to ensure that proper procedures are followed. For example, corporate or LLC by-laws, shareholder agreements, articles of organization, partnership agreements, minutes of prior meetings of the governing body, loan covenants, and state statutes governing liquidations are potential sources where one may find procedural rules and restrictions applicable to transfers.

Example: RST Corporation's shareholder agreement requires the concurrence of all shareholders before transferring shares to any other party. Therefore, if a shareholder desires to fund a CRT with his RST stock, the approval of all other shareholders should be obtained and this approval should be documented by the corporate secretary in the permanent records of the corporation. In addition, the change in ownership should be documented in the RST Corporation's stock book, the old stock certificate canceled, and a new stock certificate issued.

Example: Partner A contributes her partnership interest in ABC Partners to her CRT. The partnership agreement requires the approval of the other partners before a new partner is admitted to the partnership. This approval should be in writing in order to document the admission of the CRT into the partnership.

Example: The transfer of real estate to a CRT by a quit-claim deed may compromise the trustee's ability to issue a general warranty deed to a purchaser without incurring an unacceptable level of risk or going back to the donor to obtain a general warranty deed.

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[3] See the check-the-box regulations found at Treas. Reg. §301.7701.
[4] See IRC §170(a)(1), Treas. Reg. §1.170A-1(b) and (e).
[5] See Treas. Reg. §25.2511-2(b).

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Therefore, it is generally advisable to transfer real estate to a CRT with a general warranty deed.

Example: A partnership agreement may require that a super-majority of partners approve the transfer of an asset. Failure to observe this formality could nullify the transfer.

Example: Where a CRT has received an interest in real estate, care should be exercised to ensure that the closing paperwork on the subsequent sale accurately identifies the CRT as the seller (or as one of the sellers in the case of a fractional ownership interest).

Restrictions on Transfer

In addition to procedural requirements in order to make a transfer, there may also be restrictions on transfer. The restrictions may limit the universe of permissible transferees, trigger a sale provision in a shareholder agreement upon transfer to a transferee outside a permissible list, limit the timing of transfers, or otherwise cause unintended consequences.

Effective Date of Contribution

A contribution is generally effective on the date of delivery to the charitable recipient.[6]

Stock Gifts: The effective date of a contribution of stock in a closely-held corporation is dependent on how and to whom it is delivered. If a donor transfers a stock certificate to a CRT trustee or the trustee's agent, the effective date of the contribution is the date the certificate is mailed or otherwise delivered. On the other hand, if the donor instructs the issuing corporation to transfer shares to a CRT, the effective date of the contribution is the date the transfer is recorded on the books of the corporation.[7]

Real Estate Gift: The effective date of a contribution of real property will depend on the applicable state law. In general, the effective date is the date that the deed is signed and delivered to the CRT trustee, but not later than the date on which the deed is recorded.

Tangible Personal Property Gift: The effective date of a contribution of tangible personal property (such as equipment used in a trade or business) is the date that the CRT trustee takes possession. It is also recommended that the donor prepare a transfer document describing the property transferred and that this document be counter-signed and dated by the CRT trustee.

Substantiating The Charitable Deduction

When claiming a charitable contribution deduction for a gift to a CRT, the donor must attach to the return a statement showing the computation of the present value of the remainder interest.[8]

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[6] See Treas. Reg. §1.170A-1(b).
[7] See Treas. Reg. §1.170A-1(b).
[8] See Treas. Reg. §1.664-4(c).

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In addition, for most gifts of unmarketable assets that result in claiming or reporting a deduction greater than $5,000, a qualified appraisal must be obtained.[9] For gifts of nonpublicly traded stock, the threshold is raised to $10,000.[10] Failure to obtain a qualified appraisal will generally result in the disallowance of the income tax charitable deduction and may result in the application of negligence and other penalties. If the deduction claimed is in excess of $500,000, then a copy of the qualified appraisal must be attached to the return on which the deduction is claimed.[11]

In determining whether a qualified appraisal is required by a partnership or S-corporation, the dollar thresholds are applied at the entity level. However, where an otherwise required qualified appraisal is not obtained or is deemed deficient, the deduction is denied at the partner or shareholder level.[12]

Qualified Appraisal Defined

The Pension Protection Act of 2006 included a number of provisions that affect both qualified appraisers and qualified appraisals. Treasury and the IRS issued Notice 2006-96 to provide transitional guidance pending the release of new regulations in this area.[13] The existing regulations continue in effect except to the extent they are inconsistent with IRC §170(f)(11).[14]

A qualified appraisal is an appraisal document that:[15]

1) relates to an appraisal of the contributed property made no earlier than sixty (60) days before the contribution date, nor later than the due date of the tax return (including extensions) on which an income tax charitable deduction is first claimed;
2) is prepared, signed, and dated by a "qualified appraiser" (as described below);
3) does not involve a prohibited appraisal fee (as described below); and
4) includes the required elements described below.

Required Elements Of A Qualified Appraisal

A qualified appraisal must include the following information:[16]

1) a description of the property that is in sufficient detail to confirm that the appraised property is the contributed property;
2) in the case of tangible property, its physical condition;
3) the date (or expected date) of the contribution;
4) the terms of any agreement or understanding (or anticipated agreement or understanding) by or on behalf of the donor or donee that relates to the use, sale or other disposition of the property;

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[9] See IRC §170(f)(11)(C) and Treas. Reg. §1.170A-13(c)(2)(i).
[10] See Treas. Reg. §1.170A-13(c)(2)(ii).
[11] See IRC §170(f)(11)(D). This requirement was added by the American Jobs Creation Act for gifts after June 3, 2004.
[12] See IRC §170(f)(11)(G).
[13] See Notice 2006-96, 2006-46 IRB 902, 10/19/2006.
[14] See Notice 2006-96, Sec. 3.02(1), 2006-46 IRB 902, 10/19/2006.
[15] See Treas. Reg. §1.170A-13(c)(3)(i).
[16] See Treas. Reg. §1.170A-13(c)(3)(ii).

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5) the name, address, taxpayer ID number, or other identifying number of the appraiser, together with the capacity in which the appraiser is acting, e.g., as an individual, an employee, a partner in a partnership, etc.;
6) the appraiser's qualifications, including a statement of background, experience, education, and membership in any professional appraisal associations;
7) a statement that the appraisal was prepared for income tax purposes;
8) the date (or dates) the property was appraised;
9) the method used to establish fair market value;
10) the specific basis for the valuation, e.g., comparables, statistical sampling, etc.; and
11) the appraised fair market value on the date of the contribution.

Qualifications Of A Qualified Appraiser[17]

A qualified appraiser must:

1) perform appraisals on a regular basis, or hold himself/herself out to the public as an appraiser;[18]
2) regularly perform appraisals for compensation;[19]
3) be qualified to make appraisals of the type of property at issue because of the appraiser's personal qualifications;[20]
4) have earned an appraisal designation from a recognized professional appraiser organization or otherwise met minimum education and experience requirements;[21]
5) have verifiable education and experience in valuing the type of property being appraised;[22] and
6) not be a member of the class of persons who are statutorily disqualified from making an appraisal in a given case.[23]

In addition, the appraiser must include in the appraisal document a written declaration[24] attesting to these qualifications and affirming that he/she understands that an intentionally false or fraudulent overstatement of the value of the property may subject the appraiser to federal civil penalties and that the appraiser may have appraisals disregarded.[25]

Caution: If the donor has knowledge of facts that would cause a reasonable person to expect the appraiser to falsely overstate the value of the donated property, then the appraiser will be deemed to be disqualified, thereby invalidating the appraisal.[26]

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[17] See Treas. Reg. §1.170A-13(c)(5)(i).
[18] See Treas. Reg. §1.170A-13(c)(5)(i)(A).
[19] See IRC §170(f)(11)(E)(ii)(II).
[20] See Treas. Reg. §1.170A-13(c)(5)(i)(B).
[21] See IRC §170(f)(11)(E)(ii)(I).
[22] See IRC §170(f)(11)(E)(iii)(I).
[23] See Treas. Reg. §1.170A-13(c)(5)(i)(C).
[24] See Treas. Reg. §1.170A-13(c)(5)(i).
[25] See Treas. Reg. §1.170A-13(c)(5)(i)(D). The penalties are for aiding and abetting an understatement of tax liability. See IRC §6701.
[26] See Treas. Reg. §1.170A-13(c)(5)(ii).

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Persons Who Cannot Appraise A Particular Property

The following persons are not permitted to appraise a particular property:

1) the donor or taxpayer who is claiming the income tax charitable deduction for the contribution of the property being appraised;[27]
2) the person who sold, exchanged, or gave the property to the donor, or any person who acted as the agent for the transferor or for the donor with respect to such sale, exchange, or gift, unless the property was donated within two months of its acquisition and the appraised value does not exceed the acquisition price;[28]
3) the donee of the property;[29]
4) any person employed by the donor, donee, or any person described in item two above;[30]
5) any person who is related to any of the above-listed persons via the attribution rules of IRC §267(b), e.g., controlled companies, husband, wife, brothers, sisters, ancestors, lineal descendants, etc., plus any such persons related to the donor's spouse;[31]
6) any appraiser who is regularly used by the donor, donee, or any person described in item two above, who does not perform a majority of his/her appraisals made during his/her taxable year for other persons; [32]and
7) any appraiser who has been prohibited from practicing before the IRS during the three-year period before the appraisal date.[33]

Fees For Qualified Appraisals

No part of the fee arrangement for a qualified appraisal can be based on a percentage of the appraised value of the property.[34] However, an appraisal fee can be based on a percentage of the appraised value when all of the following factors are present:[35]

1) the appraisal fee is paid to a generally recognized Association that regulates appraisers;
2) the Association neither is organized for profit, nor pays any part of its net earnings to private shareholders or individuals;
3) the appraiser does not receive any compensation from the Association or any other person for making the appraisal; and
4) the fee arrangement is not based in whole or in part on the amount of the appraised value of the donated property that is allowed as a charitable deduction.

Deductibility of Contributions

The type of charity selected as the remainder beneficiary of a CRT will affect the income tax deduction. The IRS has ruled[36] that where one or more persons have the power to select a

[27] See Treas. Reg. §1.170A-13(c)(5)(iv)(A).
[28] See Treas. Reg. §1.170A-13(c)(5)(iv)(B).
[29] See Treas. Reg. §1.170A-13(c)(5)(iv)(C).
[30] See Treas. Reg. §1.170A-13(c)(5)(iv)(D).
[31] See Treas. Reg. §1.170A-13(c)(5)(iv)(E).
[32] See Treas. Reg. §1.170A-13(c)(5)(iv)(F).
[33] See IRC §170(f)(11)(E)(iii)(II).
[34] See Treas. Reg. §1.170A-13(c)(6)(i).
[35] See Treas. Reg. §1.170A-13(c)(6)(ii).

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private foundation as the remainder beneficiary, then the contribution to the CRT is deemed to be made to a private foundation. This rule applies even where the charity initially named in the CRT document is a public charity.

Adjusted Gross Income[37] Limitations

An individual taxpayer is permitted to claim a charitable contribution deduction to the extent of an allowable percentage of his adjusted gross income (AGI). If the contribution is deemed to have been made to a public charity, then the limit for cash contributions is 50% of AGI.[38] Likewise, if the taxpayer contributes long-term capital gain property, then the limit is 30% of AGI.[39]

If the contribution is deemed to have been made to a private foundation, then the limit for cash contributions is 30% of AGI.[40] Likewise, if the taxpayer contributes long-term capital gain property, then the limit is 20% of AGI.[41]

A C-corporation is permitted to claim an income tax charitable deduction equal to 10%[42] of its taxable income[43] regardless of the public charity or private foundation status of the permissible charitable beneficiary(ies) of the CRT.

Any unused charitable deduction may be carried forward for an additional five years.[44]

Basis Reduction Rule

In addition to the AGI limits described above, a second rule applies to contributions of appreciated property to private foundations. This rule reduces the deductible amount to the adjusted tax basis for contributions of long-term capital gain property. This basis reduction rule does not apply to most contributions of qualified appreciated stock.[45] Qualified appreciated stock is defined as stock in a corporation for which market quotations are readily available on an established securities market and the stock is capital gain property.[46]

Note that this basis reduction rule also applies to charitable contributions made by C-corporations.[47]

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[36] See Rev. Rul. 79-368.
[37] The technical term used in the statute is "contribution base." The contribution base is defined as adjusted gross income computed without regard to any net operating loss carryback to the taxable year. IRC §170(b)(1)(G).
[38] See IRC §170(b)(1)(A).
[39] See IRC §170(b)(1)(C).
[40] See IRC §170(b)(1)(B).
[41] See IRC §170(b)(1)(D).
[42] See IRC §170(b)(2)(a).
[43] For C-corporations, taxable income is computed without regard to charitable contributions [§170(b)(2)(C)(i)], net-operating loss carryback [§170(b)(2)(C)(iii)], the domestic production activities deduction under IRC §199 [§170(b)(2)(C)(iv)], and IRC §1212(a)(1) capital loss carrybacks [§170(b)(2)(C)(v)].
[44] See IRC §170(d).
[45] See IRC §170(e)(1). There are other rules that may come into play in rare circumstances.
[46] See IRC §170(e)(5).
[47] See IRC §170(e)(1).

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Tax Basis and Holding Period

In order to fully understand and quantify the tax benefits to be obtained from a contribution of a business interest to a CRT, it is important to determine the tax basis, holding period, and any other relevant tax characteristics. The ability to avoid the immediate taxation of unrealized gain upon the sale of a business transferred to a CRT is one of the primary tax benefits of a CRT. The tax basis and holding period are two of the key factors required to compute the amount of unrealized appreciation inherent in a business interest and thereby measure the tax benefit. To determine the tax basis and holding period, start by verifying how the donor acquired her interest in the business entity.

Among the ways a donor can acquire an interest in a business entity are:

- Create the business entity;
- Purchase an interest in the business entity;
- Receive an interest by gift;
- Receive an interest by bequest;
- Exercise non-qualified stock options (NQSOs); and
- Exercise incentive stock options (ISOs).

Interest Created by Donor. A business founded by the donor is likely to have little or no tax basis and therefore have significant unrealized appreciation. In addition, it is likely to have been created more than one year prior to a planned transfer to a CRT and therefore qualify as long-term capital gain property.

Interest Purchased by Donor. A donor may have purchased a business interest. In this case, the purchase price establishes the starting point for determining the donor's tax basis. When analyzing such interests for a CRT contribution, appreciated business interests purchased more than one year prior to contribution to a CRT will qualify as long-term capital gain property.

Interest Acquired by Gift. Business interests may also be acquired by gift. In this case, the donor's basis and holding period in the business interest are the same as that of the person from whom they received the business interest.[48] An adjustment is permitted for gift tax paid.[49]

Interest Acquired by Testamentary Transfer. Business interests acquired by testamentary transfer will generally have received a "step-up" in basis to the value included in the decedent's estate.[50] In addition, all such transfers are automatically treated as long-term capital gain property, regardless of the decedent's actual holding period. If the property was only recently acquired from the decedent's estate, then the amount of appreciation may be negligible.

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[48] See IRC §1015(a)(1) and Treas. Reg. §1.1015-1(a)(1) for the rule regarding carryover of basis. See IRC §1223(2) for the rule regarding the tacking of the holding period.
[49] See IRC §1015(d) and Treas. Reg. §1.1015-5.
[50] See IRC §1014(a).

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Interest Acquired by Exercise of Non-qualified Stock Options. Where a business interest was acquired by the exercise of non-qualified stock options,[51] the donor's basis will generally be equal to the fair market value of the stock on the date the options were exercised.[52] The holding period is determined by reference to the date the options were exercised, not the date the options were granted.[53] Therefore, the stock will be long-term capital gain property where the options were exercised more than one year prior to contribution to a CRT.

Interest Acquired by Exercise of Incentive Stock Options. Where a business interest was acquired by the exercise of ISOs,[54] the donor's basis for regular tax is equal to the option strike price—so long as the option was granted more than two years prior to the sale of the stock and the stock is sold more than one year after the exercise of the stock option.

However, because the excess of the fair market value of the underlying stock at the time of exercise over the strike price is a preference item for alternative minimum tax (AMT) purposes,[55] a donor's adjusted tax basis for AMT is equal to the fair market value at the time of exercise. The difference between the regular tax treatment of ISOs and the AMT treatment of ISOs may give rise to an AMT credit that will significantly reduce the tax paid upon sale of the business interest.

Because the ability to use the AMT credit becomes limited when the stock that gave rise to the credit is used to make charitable contributions, the suitability of using such stock must be reviewed. For some donors, the loss of the ability to use the AMT credit may be outweighed by their desire to make the charitable gift.

Self-Dealing From Business-Used Real Estate

An issue that is peculiar to small business owners is the common practice of owning real estate used by the family business separate from the family business. This practice may result in self-dealing when the family business, or a portion of it, is contributed to a CRT. The payment of rent by a CRT to a disqualified person is self-dealing.[56] A limited exception to the self-dealing rules may apply if the payment of rent is suspended.[57]

A second approach to addressing this common problem is to transfer the real property to the CRT at the same time as the family business. However, there is a hidden trap in this solution if the corporation continues to pay rent. Rents received by a CRT from a controlled entity are treated as UBTI.[58]

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[51] Note that the rules regarding the transfers of non-qualified stock options *prior to exercise* are beyond the scope of this paper.
[52] See Treas. Reg. §1.61-2(d)(2)(i).
[53] See IRC §83(f).
[54] See IRC §422 for the definition of incentive stock options.
[55] See IRC §56(b)(3).
[56] See IRC §4941(d)(1)(A) and Treas. Reg. §53.4941(d)-2(b)(1).
[57] See Treas. Reg. §53.4941(d)-2(b)(2).
[58] See IRC §512(b)(13) and Treas. Reg. §1.512(b)-1(l).

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Assignment of Income

It is a basic principle of federal income tax law that income is taxed to the taxpayer who earns it.[59] The assignment of income doctrine prohibits the shifting of the income tax liability associated with recognition of gain away from a party whose right to the gain has matured.

Business owners contemplating funding a CRT most often encounter an assignment of income problem where the sale of the business is largely completed before title to their ownership interest is transferred to a CRT.

> **The *Kinsey* Case.** A court[60] ruled that where a plan of liquidation was adopted prior to the transfer of stock to a charity, the subsequent transfer of stock was ineffective in transferring the associated gain away from the donor to the charity.
>
> **The *Salvatore* Case.** Similarly, a court[61] held that the transfer of stock in a corporation to a child, after a formal sales agreement with a third party had already been signed, violated the assignment of income doctrine.
>
> **The *Jorgl* Case.** A court[62] held that where a corporation was sold by a CRT and the sales agreement included a covenant not to compete, the value of the noncompete agreement was properly assignable as income to the party bound by the covenant, notwithstanding the fact that the consideration for the covenant was paid to the CRT.
>
> **The *Greene* Case.** Alternatively, a court[63] held that where the receiving charity was expressly and solely in control of the decision of when to sell, the donor's right to the gain had not sufficiently matured and the donor was therefore not liable for tax on the gain. The court found this to be true, even though the donor was a member of the donee charity's board of directors; because a trustee other than the donor had control over the sale of assets contributed by the donor.
>
> **The *Palmer* Case.** A court[64] ruled that a contribution of stock in a corporation to a private foundation, followed by the corporation's independent offer to redeem the stock, followed by the foundation's acceptance of the redemption offer did not violate the assignment of income doctrine. This was found to be true, even though the donor had voting control of both the corporation and the recipient private foundation. One key to the court's favorable ruling was that each decision made by the respective parties was arrived at independently of the other decisions (i.e., the decisions were not part of an integrated plan that would create grounds for a finding that a step transaction had occurred). The IRS issued Rev. Rul. 78-197[65] acquiescing to the outcome of the Palmer case stating:

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[59] *Lucas v. Earl*, 281 U.S. 111, 8 AFTR 2d 10287, 1930.
[60] See *Kinsey v. Comm.*, 477 F.2d 1058, 31 AFTR 2d 73-1262, (2d Cir. 1973)
[61] See *Salvatore v. Comm.*, 434 F.2d 600, 26 AFTR2d 70-5857, (2d Cir. 1970).
[62] See *Jorgl v. Comm.*, 264 F.3d 1145, 88 AFTR 2d 2001-5182 (11th Cir. 2001).
[63] See *Greene v. U.S.*, 13 F.3d 577, 73 AFTR 2d 94-746, (2d Cir. 1994).
[64] See *Palmer v. Comm.*, 62 T.C. 684 (1974), aff'd on another issue, 523 F.2d 1308 (8th Cir. 1975).
[65] See 1978-1 CB 83.

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> The Service will treat the proceeds of a redemption of stock under facts similar to those in *Palmer* as income to the donor only if the donee is legally bound, or can be compelled by the corporation, to surrender the shares for redemption.

Where negotiations have already commenced prior to a transfer to a CRT, prudence dictates that negotiations be halted, the transfer to the CRT completed, and then, negotiations resumed. Where the CRT is the controlling party after the transfer, the CRT's trustee should control the negotiations (either directly or through a duly authorized agent). Where the CRT is not the controlling party (e.g., in the case of a partial transfer to a CRT), the trustee should take care to exercise all rights and duties of ownership as appropriate. In addition, it is generally prudent for an independent trustee[66] (or independent special trustee) to represent the CRT in all negotiations and the close of the sale.

As a final note, a finding that there has been an assignment of income does not disqualify the CRT. The CRT continues to be a validly created trust under state law, is still a tax-exempt entity under IRC §664, the contributed assets are still effectively removed (in most cases) from the donor's taxable estate, and the donor still receives an income tax deduction.[67]

Asset Sale vs. Stock Sale

It is common for the sale of a closely-held business to be structured as the purchase of the entity's assets rather than the sale of the legal entity. From the buyer's perspective this makes sense for one or more of the following reasons:

- The buyer wants to avoid becoming responsible for the liabilities (identified or unidentified) of the seller;
- The buyer only wants to acquire a portion of the assets of the business entity; or
- The buyer wants to reset the basis for depreciation.

Since the repeal of the *General Utilities*[68] doctrine by the Tax Reform Act of 1986, the corporate-level tax cannot be avoided by distributing the assets of the corporation in-kind to its shareholders. Since 1986, when a corporation sells its assets and then distributes the cash proceeds to its shareholders, tax is paid by the corporation on the sale of the assets and also by the shareholder upon the liquidation of the corporation.

A consequence of this double-taxation regime on corporate liquidations is that a CRT cannot shelter from taxation the corporate-level tax resulting from an asset sale. However, where it is possible to sell the stock of a corporation to a prospective buyer, a CRT can avoid the immediate taxation of the gain realized upon the sale of the corporation.

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[66] For the definition of an independent trustee, see IRC §674(c) and Treas. Reg. §1.664-1(a)(7).
[67] Arguably in this case, the deduction should properly be treated as a cash contribution. This will result in an enhanced deduction (higher AGI limitation) that can be used to partially offset the newly assigned income.
[68] In *General Utilities & Operating Co. v. Helvering*, 16 AFTR 1126 (56 S.Ct. 185), 12/09/1935, the Court allowed a corporation to avoid recognition of gain upon the distribution of appreciated property to its shareholders.

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Where assets of the corporation are distributed in-kind in liquidation of a corporation, taxable gain is deemed to be realized by the corporation immediately prior to distribution to the extent that the fair market value of the assets distributed exceeds the corporation's adjusted basis in the assets.[69]

Each shareholder is then subjected to a shareholder-level tax on the liquidating distribution. If the distribution is a distribution in complete liquidation of the corporation, then the shareholder is considered to have sold a capital asset. The gain realized is the excess of the fair market value of the assets received over the shareholder's adjusted basis in the corporate stock.[70]

> **Example**: Paul Hussey, the 100% shareholder of Hussey Publishing, Inc. (HPI), a C-corporation, transfers 75% of his shares to a CRT. Then Paul and the CRT trustee sell their stock in the company to BigPub, Inc. HPI will owe no corporate level tax on this transaction. Both Paul and the CRT receive the undiminished proceeds from the sale of the stock. While Paul will claim a taxable gain to the extent of his retained 25% interest, the CRT will pay no tax on the gain realized on its 75% interest. Note, however, that this gain is recorded in the class of "all other long-term capital gains and losses" in Tier 2 of the 4-tiers.
>
> **Example:** The facts remain the same as the previous example, except that BigPub, Inc. is only willing to purchase the assets of HPI. In this case, HPI must first pay a corporate level tax on the gain realized from the sale of its assets to BigPub, Inc. Upon the subsequent complete liquidation of HPI, the net proceeds (after paying the corporate-level tax) are then distributed to Paul and the CRT. Paul will then pay a second, shareholder level tax on his 25% retained interest in HPI and the CRT will pay no tax on the gain realized from its 75% interest. As noted in the previous example, this gain is recorded in the class of "all other long-term capital gains and losses" in Tier 2 of the 4-tiers.

Partial Asset Sales. Where a partial asset sale is followed by a distribution of the proceeds, the distribution is generally first taxed as a dividend to the extent of the corporation's undistributed earnings and profits, second as a return of the shareholder's basis in the corporation, and third as gain to the extent of the remainder of the distribution.[71] Where the distribution is a redemption of stock, other rules may apply that may treat the distribution as a sale of the redeemed stock.[72]

Selected Risks

Risk of Delayed Sale

Illiquidity. The market for closely-held business interests is limited and, therefore, a closely-held business interest is inherently an illiquid asset. As a result of this illiquidity, the trustee may experience difficulty in funding required distributions and paying carrying costs.

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[69] See IRC §§311(b) and 336(a).
[70] See IRC §331(a).
[71] See IRC §301.
[72] See the rules under IRC §§302 and 303.

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When contemplating a transfer to a CRT, the impact of this limited marketability and illiquidity should affect the CRT format selected and/or the decision to contribute additional, liquid assets.

To eliminate the problem created by required distributions and illiquidity, it is common to select the net-income with make-up charitable remainder unitrust (NIMCRUT) or flip charitable remainder unitrust (Flip-CRUT) format. In either of these formats, the trustee should only be required to distribute net income, thereby more closely matching required distributions to available liquidity.

Potential Requirement To Make an In-Kind Distribution. Where a distribution is required (e.g., because the CRAT or SCRUT format was selected) and there is inadequate liquidity to fund the distribution, the CRT trustee may be required to make an in-kind fractional interest distribution to the CRT beneficiary. This type of distribution creates at least two problems:

- Valuation of the property to be transferred; and
- Taxation of the property distributed to the beneficiary.

In the case of valuing the property, the trustee will likely incur the cost of an appraisal as well as any costs associated with re-titling a fractional interest.

When a CRT distributes property in-kind in satisfaction of a required distribution, the trustee is deemed to have sold the distributed property immediately prior to the distribution.[73] To the extent that the fair market value of the property distributed exceeds the CRT's adjusted basis in the property, the CRT trustee must record the gain in the capital gain tier. This gain is then available to be used to determine the tax character of the distribution in the hands of the income beneficiary as reported on form Schedule K-1. The income beneficiary is then confronted with reporting taxable income, but not having received cash from the CRT with which to pay the tax.

Requirement To Periodically Value the CRT's Assets and Liabilities. Ownership of unmarketable assets provides an ongoing challenge to CRT administration because of the periodic requirement to value the trust's assets and liabilities and the need to substantiate the basis for the value used. A CRT trustee will need the value of the trust's assets and liabilities in order to:

- Determine the value of the trust's assets and liabilities in order to compute the unitrust amount;
- Value any additional contribution for the incremental change in the unitrust amount for the year of contribution; and
- Compute the fraction of the entity to transfer to make an in-kind distribution in satisfaction of a required distribution.

A CRT trustee may substantiate the value of the trust's assets and liabilities by obtaining a qualified appraisal or using a value determined by an independent trustee.[74] The value of a

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[73] See Treas. Reg. §1.664-1(d)(5).
[74] See Treas. Reg. §1.664-1(a)(7).

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contributed business interest should consider the applicability of discounts, including discounts for lack of marketability and minority interests. The value of a real property interest should consider the applicability of discounts for the presence of environmental contamination, fractional ownership interests, and other impediments to sale.

Risk Associated With Encumbered Property

The transfer of encumbered property to a CRT has the potential to create several problems.

When a CRT receives property subject to a loan, income generated by that property (including gain on the sale of the property) creates unrelated debt-financed income (UDFI),[75] a form of unrelated business taxable income (UBTI).[76] UBTI received by a CRT is subject to a 100% excise tax as described below.

In addition to UBTI concerns, if a CRT trustee accepts responsibility for a donor's obligation to pay a debt associated with encumbered property, then the trustee and the donor have engaged in a prohibited act of self-dealing.[77] Acts of self-dealing require the payment of excise taxes by both the trustee and the donor as well as reporting and corrective actions.

The transfer of encumbered property to a CRT will result in the deemed sale of a fractional portion of the encumbered property and recognition of capital gain by the donor. The amount deemed realized is equal to the debt.[78] To compute the taxable gain, a portion of the donor's basis in the property is allocated to the amount deemed realized. The basis allocated is computed by first dividing the amount of the debt by the fair market value of the property, and then multiplying this fraction by the donor's adjusted basis in the property.[79] The donor's remaining, unallocated basis becomes the CRT's basis in the property.

A similar result will be reached where a donor contributes a partnership interest and the partnership is liable for indebtedness. In this case the value of the donor's share of the partnership liabilities is treated as amount realized from the sale of property (i.e., sale proceeds). To arrive at the taxable amount, the "sale proceeds" are reduced by an allocable share of the donor's adjusted basis in his partnership interest.[80]

When computing the contribution deduction for property subject to a mortgage or other encumbrance, the value of the property is first reduced by the value of the encumbrance.

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[75] See IRC §514(b).

[76] IRC §514(c)(2)(B) provides that for ten years after contribution, the general rule that a mortgage creates acquisition indebtedness does not apply where the CRT acquires property by gift *subject to* a mortgage placed on the property more than five years before the gift and the donor held the property for more than five years.

[77] See IRC §4941(d)(2)(a) and Treas. Reg. §53.4941(d)-2(a)(2). Treas. Reg. §53.4941(d)-2(a)(2) provides a limited exception to the general prohibition against self-dealing where a CRT trustee accepts encumbered property *subject to* an outstanding indebtedness that was placed on the property by a disqualified person 10 or more years prior to the transfer of the property to the trust.

[78] See Treas. Reg. §1.1011-2(a)(3).

[79] See IRC §1011(b).

[80] See Rev. Rul. 75-194.

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Where a CRT's income is used (or may be used in the discretion of a nonadverse trustee) to satisfy an obligation of a donor, then the CRT will be treated as a grantor trust and fail to qualify as a CRT.[81]

Risk Arising From Unrelated Business Taxable Income (UBTI)

When a CRT receives unrelated business taxable income, such income is subject to a 100% excise tax.[82] Therefore, where assets of an operating business are the subject of a proposed transfer to a CRT, consideration must be given to whether such assets will create UBTI.

> **Example**: J. Danforth, Inc., an S-corporation, transfers a multi-family apartment building to a CRT. Most real property rents received by a CRT meet an exception to the definition of UBTI.[83] Therefore, rents received by the CRT are not UBTI.

> **Example**: J. L. Lissberger, Inc., an S-corporation, owns as its sole asset a furnished vacation condominium. The corporation transfers 35% of its interest in the condominium to a CRT. Four percent (4%) of the weekly rental receipts are allocable to the rental of the furnishings. So long as no more than 10% of the rents received are allocable to personal property, then none of the rents received by the CRT are UBTI.[84]

> **Example**: Carter Excavating, Inc. (CEI) routinely liquidates fully depreciated, obsolete equipment that is no longer used in its trade or business—often at a gain. CEI elects to transfer this obsolete equipment to a CRT. Gain generated from the sale of property meets one of the exceptions to the definition of UBTI.[85] Therefore, gains received by the CRT are not UBTI.

> **Example**: Carter Excavating, Inc. (CEI) has been approached by a competitor with an offer to purchase all of its assets (including equipment, land, and goodwill). Bob Carter would like to avoid a portion of the gain on the sale of CEI's assets by transferring 60% of the assets of CEI to a CRT. However, as a going concern, Bob would like to continue to operate CEI during the period from the time of contribution to the subsequent sale of the assets. Because CEI's income from operations is gross income from an unrelated trade or business,[86] the income generated during this period is UBTI.[87]

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[81] See IRC §677(a)(1), Treas. Reg. §1.677(a)-1(d), and PLR 9015049.

[82] See IRC §664(c)(2). This is the rule for CRTs that receive UBTI for tax years beginning January 1, 2007. Under prior law, a CRT lost its exempt status for any year in which if received UBTI.

[83] See IRC §512(b)(3). This exception is not available where more than 50% of the rents received are attributable to the rental of personal property or any portion of the rents received is based upon the income or profit derived by any person from the leased property.

[84] See Treas. Reg. §1.512(b)-1(c)(2)(ii)(b).

[85] See IRC §512(b)(5).

[86] IRC §513(a) states in part "The term 'unrelated trade or business' means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption ***under section 501*** (or, in the case of an organization described in section 511(a)(2)(B) , to the exercise or performance of any purpose or function described in section 501(c)(3))" [emphasis added]. A CRT derives its exemption from income tax from IRC §664, not §501. Therefore, it is not possible for a CRT to qualify

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Technique #1-Sale of a Corporation Through a CRT

The most straightforward technique for using a CRT with a business owner is for the business owner to contribute corporate stock to a CRT. A common motivation for creating a CRT is the expected sale of the family business coupled with charitable goals.

Example: John and Judy Freeman, both age 65, have owned and operated Freeman Enterprises, Inc (FEI). for the past 35 years. A number of competitors have made inquiries regarding the Freemans' desire to sell. John and Judy are ready to retire and want to give something back to their community.

FEI is currently valued at $10 million. John and Judy's tax basis is less than $100,000. Their overall net worth is $12 million not including their personal residence.

After considering their other estate planning goals and liquidity needs, John and Judy decide in conjunction with their advisors that a transfer of 30% of the outstanding FEI stock to their CRT is appropriate. The gift planning team recommends that the CRT utilize a flip provision to minimize the risk associated with a delayed sale. The advisors are careful to ensure that the CRT's remainder interest must be paid to a public charity. John and Judy also obtain a qualified appraisal for their transfer of 30% of the FEI stock to their CRT in order to substantiate their charitable income tax deduction.

After the contribution, the CRT trustee successfully negotiates the sale of the FEI stock to a major competitor.

As a result, the gain on the sale of FEI that is attributable to the CRT is sheltered from immediate taxation. John and Judy receive a current income tax deduction, a unitrust interest for life, and the value transferred to the CRT is removed from their taxable estate. At the death of the survivor, a significant gift will be made to charities in their community.

Additional Considerations Unique To S-Corporations

Termination of S-Election

As an impermissible shareholder of an S-corporation,[88] the transfer of even one share of stock in an S-corporation to a CRT will trigger the immediate termination of the corporation's S-election.[89] The effect of this termination is to create two taxable years within the calendar year in which the S-election terminates—one for the period of the calendar year for which the corporation was an S-corporation, and one for the period of the year for which the corporation was a C-corporation.

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for an exemption from unrelated business classification by virtue of claiming that a trade or business is substantially related to the purpose for which it was granted an exemption.

[87] See IRC §512(a)(1).

[88] See IRC §1361(b)(1)(B) for the definition of permissible shareholders.

[89] See IRC §1362(d)(2)(B).

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Planning Pointer

If stock in an S-corporation is to be transferred to a CRT, the S-election should be affirmatively revoked prior to (or concurrently with) the transfer to the CRT. By making an affirmative revocation, it should be clear to all parties that the S-election is being terminated.

While the loss of an S-election should not be taken lightly, it is not necessarily catastrophic. If the plan is to sell the stock contributed to the CRT or exchange the stock for stock in a publicly traded company, then the loss of the S-election is generally a nonevent.

However, a number of negative factors should be considered:

- Double taxation of corporate earnings;
- Assuming only a portion of the outstanding shares were transferred to the CRT, the CRT trustee is now a co-shareholder with fiduciary duties that may impose a different agenda;
- Requirement to obtain additional updated qualified appraisals or valuations by an independent trustee; and/or
- Unanticipated delays in selling the stock will increase the possibility that a self-dealing transaction may occur.

Re-electing S-Status By a Subsequent Purchaser

A common concern raised when the S-election is terminated, is the ability of the new ownership to re-elect S-status following the purchase of the corporation. The general rule is that a corporation may not re-elect S-status until five years after the termination of the S-election.[90] The IRC permits an early re-election if the Treasury Secretary consents.[91] The regulations provide that consent generally should be granted, when more than 50% of the stock in the corporation is owned by persons that were not shareholders at the time the S-election was previously terminated. The new shareholders must formally petition the IRS for consent to re-elect S-status, but the ruling history has generally been favorable so long as the requirements of the regulations have been met.[92]

[90] See IRC §1362(g).
[91] See IRC §1362(g).
[92] See Treas. Reg. §1.1362-5(a). See also PLRs 9002043, 9003057, 9009015, 9014059, 9027015, 9045006, and 9050050, among others.

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Technique #2-Redemption Of Stock From the CRT By the Corporation

If a corporation has sufficient cash reserves and/or cash flow from operations, it may be desirable for a principal shareholder to contribute stock in the corporation to a CRT, after which the corporation's board of directors extends a redemption offer. This technique can be a powerful method for funding an exit strategy and/or business succession plan using the tax-advantaged leverage of a CRT.

Example: Jerry and Tanya Simmons, both age 63, have owned and operated Simmons Industries, Inc (SII) for the past 40 years. They have two children, JJ and Samantha, who are actively involved in the business and will succeed into ownership and senior management positions upon the Simmons' retirement.

SII is currently valued at $8,000,000 and has 1,000,000 shares outstanding. SII currently has $1.5 million in cash and is producing free cash flow in excess of $600,000 per year.

Jerry and Tanya are ready to phase out of their participation in the company and turn over the reins to JJ and Samantha. Their planning team recommends that Jerry and Tanya implement a plan that involves the systematic transfer of SII stock to a CRT followed by the redemption and retirement of that stock.

To kick-start the plan, Jerry and Tanya make a gift to JJ and Samantha of 1,500 shares each of SII stock (approximate value equal to $12,000, or the current gift tax annual exclusion amount). Jerry and Tanya then transfer 125,000 shares of SII stock (approximately $1,000,000) to a lifetime CRT for Jerry and Tanya's benefit. After this transfer, the ownership structure of SII is as follows:

Table 2

Shareholder	Number of Shares	Percent of Ownership
Jerry and Tanya Simmons	872,000	87.20%
JJ Simmons	1,500	0.15%
Samantha Simmons	1,500	0.15%
Jerry and Tanya Simmons CRUT	125,000	12.50%
Total	**1,000,000**	**100.00%**

After the transfer, Jerry and Tanya, in their position as majority shareholders, cause SII to extend an offer to all shareholders to redeem up to 125,000 shares at their fair market value. The CRT trustee is the only party to accept the redemption offer. The shares are redeemed and subsequently retired. The new ownership structure is as follows:

Table 3

Shareholder	Number of Shares	Percent of Ownership
Jerry and Tanya Simmons	872,000	99.66%
JJ Simmons	1,500	0.17%
Samantha Simmons	1,500	0.17%

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Shareholder	Number of Shares	Percent of Ownership
Jerry and Tanya Simmons CRUT	0	0.00%
Total	**875,000**	**100.00%**

Over the next several years this process is repeated, with the number of shares redeemed varying according to SII's available cash. At the end of 10 years, the ownership structure is as follows:

Table 4

Shareholder	Number of Shares	Percent of Ownership
Jerry and Tanya Simmons	375,000	91.46%
JJ Simmons	17,500	4.27%
Samantha Simmons	17,500	4.27%
Jerry and Tanya Simmons CRUT	0	0.00%
Total	**410,000**	**100.00%**

In addition, approximately $5,000,000 has been transferred to Jerry and Tanya's CRT.

While the most prudent CRT format to select when transferring unmarketable stock of a family business to a CRT is the NIMCRUT or Flip-CRUT, Jerry and Tanya's CRT is a standard charitable remainder unitrust (SCRUT) because the mechanics of a stock redemption under this scenario do not require negotiations with an outside party.

In addition, the advisors are careful to ensure that the CRT's remainder interest must be paid to a public charity so that Jerry and Tanya may claim an income tax deduction based on the fair market value of the SII stock transferred to the CRT.

In order to substantiate the income tax deduction and comply with the requirements of the limited exception to the self-dealing rules for corporate reorganizations (discussed below), a qualified appraisal is obtained valuing each transfer and redemption.

As a result, the tax consequences of each redemption are sheltered by the CRT; Jerry and Tanya receive an income tax deduction for each contribution to their CRT, a unitrust interest for life, and the value transferred to their CRT is removed from their taxable estate; and, over time, JJ and Samantha's ownership percentages grow. At the death of the survivor of Jerry and Tanya, a significant gift will be made to charities in their community.

Additional Considerations When Combining CRTs With Stock Redemptions

Initiating the Plan

In many stock redemption plans, a key component is the eventual transfer of control to children or key employees. In order to achieve this goal, the children or key employees must begin with a fractional interest in the corporation. Where children are concerned, annual exclusion gifts, lifetime exclusion gifts, or even taxable gifts may be utilized to "prime the pump." Where

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children are employed by the corporation or key employees are the intended successor owners, nonqualified stock options may be granted with bonuses paid to fund the exercise of the options.

Tax Treatment of Redemption Proceeds

If stock is treated as redeemed for income tax purposes, then the transaction may be treated as the sale or exchange of a capital asset and may qualify for capital gain treatment (so long as the stock otherwise meets the definition of a capital asset). In the following cases, a redemption is treated as payment in exchange for the stock:

1. A redemption that is "substantially disproportionate" with respect to the redeeming shareholder,[93]
2. A complete redemption of all of a shareholder's stock in the corporation,[94]
3. A redemption that is "not essentially equivalent to a dividend,"[95]
4. A redemption of stock held by a noncorporate shareholder, in partial liquidation of the distributing corporation,[96] or
5. A redemption of a decedent's stock to pay death taxes.[97]

In most cases involving a family business, constructive ownership rules[98] will apply that will prevent a redemption of stock from a CRT from qualifying for capital gain treatment until the donor's ownership position declines below 50%. As a result, redemptions of a corporation's stock are generally treated as a distribution to the shareholder. Distributions to shareholders are taxed first as a dividend to the extent of the corporation's earnings and profits, next as a return of the shareholder's basis to the extent of the shareholder's basis, and finally as long-term capital gain to the extent of the remainder of the distribution.[99] A distribution classified as a dividend should be eligible for treatment as a qualified dividend.[100]

Self-Dealing

In general, when a substantial contributor to a CRT is a greater than 35% shareholder of a corporation, the corporation is a disqualified person with respect to the CRT.[101] Therefore, barring an exception, the corporation's redemption of stock from the CRT is a prohibited act of self-dealing.[102] However, there is a noteworthy exception for many types of corporate reorganizations.[103] In order for a redemption offer to qualify for this exception:

- All of the securities of the same class as that held by the CRT must be subject to the same terms, and

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[93] See IRC §302(b)(2).
[94] See IRC §302(b)(3).
[95] See IRC §302(b)(1).
[96] See IRC §302(b)(4).
[97] See IRC §303(a).
[98] See IRC §318(a)(3)(B)(i).
[99] See IRC §301(c).
[100] See IRC §1(h)(11)(B) for the definition of a qualified dividend.
[101] See IRC §4946(a)(1)(E) and Treas. Reg. §53.4946-1(a)(1)(v). Applicable attribution rules require the aggregation of company stock owned by other disqualified persons related to the substantial contributor in determining the whether the 35% threshold is exceeded.
[102] See IRC §4941(d)(1)(A) and Treas. Reg. §53.4941(d)-2(a)(1).
[103] See IRC §4941(d)(2)(F) and Treas. Reg. §53.4941(d)-3(d).

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- The CRT must receive no less than fair market value.

The regulations further explain that:

> [A]ll of the securities are not subject to the same terms unless, pursuant to such transaction, the corporation makes a bona fide offer on a uniform basis to the foundation and every other person who holds such securities.[104]

A number of cases have considered whether a charitable gift followed by a stock redemption resulted in the assignment of income from the donor to the charitable recipient, most notably *Palmer v. Comm*.[105] As noted elsewhere in this paper, the IRS ultimately acquiesced[106] to the result in the *Palmer* case and concluded that the proceeds from the redemption of stock will not be an assignment of income to the donor where at the time of the gift the charitable recipient:

- Is not legally bound to surrender the shares for redemption; and
- Cannot be compelled to surrender the shares for redemption.

The redemption of stock in exchange for a note or other extension should be avoided in order to prevent a prohibited act of self-dealing.[107]

[104] See Treas. Reg. §53.4941(d)-3(d)(1).
[105] See *Palmer v. Comm.,* 62 T.C. 684 (1974).
[106] See Rev. Rul. 78-197, 1978-1 CB 83.
[107] See IRC §4941(d)(1)(B) and Treas. Reg. §53.4941(d)-3(d)(2), Example (2).

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Technique #3-Corporation Creates a CRT

CRTs are often proposed when a business entity is to be sold. As noted above in the section entitled "Asset Sale vs. Stock Sale", buyers frequently prefer to purchase the assets of a corporation rather than the stock of the corporation. An asset sale generally produces unfavorable tax results for the business owner. A solution may be for the corporation to create a CRT and transfer assets to the trust. The IRS has held that C-corporations[108] and S-corporations[109] are permissible settlors of a CRT.

Example: Debbie Hoyt, age 65, owns a strip mall that is in the path of a planned redevelopment project. Estimates are that Debbie's property is worth $7 milllion. Many years ago, Debbie's tax advisor counseled her to transfer the strip mall to a C-corporation, Hoyt Realty Corporation (HRC). HRC's depreciated basis in the property is $60,000. Debbie's overall net worth is $10 million not including her personal residence.

Debbie is ready to relinquish the management responsibilities associated with the property and is looking forward to funding her retirement with the proceeds from the sale of the property. In addition, Debbie wants to endow a scholarship at the local community college.

It is clear that the developer has no interest in purchasing the stock of HRC. Therefore, Debbie is now faced with a double tax on the proposed sale of the property to the new developer.

In conjunction with Debbie's other financial and estate planning goals and after confirming that there is no outstanding debt on the strip mall, Debbie's gift planning team recommends that HRC create a CRT and transfer a 1/7th fractional interest to the CRT. HRC will be the income beneficiary of the CRT and the CRT will be designed to terminate at the end of 20 years. HRC obtains a qualified appraisal for its transfer of a 1/7th fractional interest in the strip mall to a CRT, in order to substantiate its charitable income tax deduction.

The gift planning team further recommends that the CRT utilize a flip provision to minimize the risk associated with a delayed sale. Debbie's attorney is careful to ensure that the CRT's remainder interest must be paid to a public charity.

As a result, approximately 14% of the gain on the sale of the strip mall is sheltered from immediate taxation. HRC receives a current income tax deduction, a unitrust interest for the next 20 years, and indirectly the value transferred to the CRT is removed from Debbie's taxable estate. After expiration of the 20-year term, the local community college will receive funds to create an endowed scholarship in Debbie's name.

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[108] See PLRs 8102093 and 9205031.
[109] See PLRs 9340043 and 200644013.

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Additional Considerations Where a Corporation Is the Settlor of a CRT

Selection of the Income Beneficiary

The Code and the regulations permit any person[110] to be named as the income beneficiary of a CRT so long as at least one beneficiary is not a charitable organization.[111] When there is a valid business purpose, it is possible to name someone other than the corporation as the income beneficiary of a CRT created by a corporation (e.g., the business's owners or a key employee).[112] However, the IRS held in PLR 200203034 that, in the case of an S-corporation that established a CRT and named a person other than the corporation as the income beneficiary without a valid business purpose, the trust failed to meet the statutory definition of a trust and therefore did not qualify as a CRT.

A second consequence of naming a person other than the corporation as the income beneficiary is that the corporation is treated as having made a constructive distribution.[113] Depending on the relationship of the individual to the corporation and/or its owners, this constructive distribution may be classified as a dividend, compensation, and/or a gift.

As a result, corporations that create CRTs are advised to name themselves as the sole income beneficiary.

Selection of Trust Term

When a corporation is the sole income beneficiary of a CRT (as discussed in the previous section), the Code requires that the trust term be a term certain not to exceed 20 years.[114] While the maximum term is 20 years, consideration should be given to shorter terms. Often marrying shorter terms with higher payout rates will produce attractive results.

Claiming the Income Tax Deduction

Contributions By C-Corporations. Where a C-corporation is the settlor of a CRT, the contribution deduction is claimed by the corporation, not the shareholders of the corporation.

Contributions By S-Corporations. As a pass-through entity, when an S-corporation contributes assets to a CRT, the resulting charitable deduction passes through to the shareholders in proportion to their ownership interest. A shareholder's ability to use her deduction is limited to her basis in the corporation.[115] Charitable contribution deductions disallowed because of insufficient basis are suspended until such time as the shareholder has basis.[116]

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[110] IRC §7701(a)(1) defines a "person" as an individual, trust, estate, association, company, corporation, and partnership.
[111] See IRC §664(d)(1)(A) and Treas. Reg. §1.664-2(a)(3)(1) for annuity trusts. See IRC §664(d)(2)(A) and Treas. Reg. §1.664-3(a)(3)(1) for unitrusts.
[112] A discussion of valid business purposes for creating a CRT that names an individual as an income beneficiary is beyond the scope of this paper. However, an example might include using a CRT as an alternative form of executive compensation.
[113] See Treas. Reg. §1.671-2(e)(4).
[114] See IRC §664(d)(1)(A) for annuity trusts and IRC §664(d)(2)(A) for unitrusts.
[115] See IRC §1366(d)(1).
[116] See IRC §1366(d)(2).

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The S-corporation basis reduction rule of IRC §1367(a)(2)(B) generally requires the reduction of basis by the value of the property contributed. In addition, unrealized gains do not increase a shareholder's S-corporation basis. Therefore, charitable contributions of appreciated property by an S-corporation are generally subject to adverse treatment.

The Pension Protection Act of 2006 has temporarily provided relief by altering the basis reduction rule. For charitable contributions of appreciated property made by S-corporations prior to January 1, 2008, a shareholder is now permitted to reduce her basis by an amount equal to her pro-rata share of the corporation's adjusted basis in the contributed asset.[117] This has the effect of permitting an S-corporation shareholder to deduct more of her S-corporation's charitable contributions of appreciated property.

If there is sufficient basis to claim a charitable contribution deduction, then the individual shareholder is subject to the IRC §170(b) adjusted gross income limitations on deductibility and the five-year carryover period of IRC §170(d).

Where appreciated property is contributed by an S-corporation to a private foundation (or to a CRT in which a private foundation *could* be a remainder beneficiary), the Schedule K-1 provided to each shareholder should clarify the tax status of the charitable recipient and report the adjusted tax basis of the contributed property so that each shareholder can properly apply the limitation that reduces the deductible amount to the adjusted tax basis of the contributed property.[118]

Qualified Appraisal Required. Where otherwise required, a corporation (C- or S-) must obtain a qualified appraisal to substantiate the value of the property contributed.[119]

Continued Existence of the Corporation

C-Corporation. As noted above, where a C-corporation is the settlor of a CRT, it should also be the income beneficiary of the CRT. As a result, the C-corporation should continue in existence for the duration of the term of the CRT. Distributions from the CRT should be paid directly to the C-corporation. The CRT will also issue a Schedule K-1 each year which will define the tax character of the CRT distributions received by the C-corporation for use in preparing its annual income tax return.

If the shareholders wish to receive cash, then the directors of the corporation must declare a dividend to all shareholders, make shareholder loans, redeem stock, or utilize other methods commonly used to transfer cash from a corporation.

Where the majority of the income received by the corporation is from the CRT, the corporation may be classified as a personal holding company.[120] If a corporation is a personal holding

[117] See the final paragraph of IRC §1367(a)(2).
[118] See IRC §170(e)(1).
[119] See IRC §170(f)(11)(A). This requirement was extended to C-corporations by the American Jobs Creation Act for gifts after June 3, 2004.
[120] See IRC §542.

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company, then it is subject to a 15% penalty tax[121] on its undistributed personal holding company income.[122] Two common solutions to avoid the imposition of this penalty tax are:

1. Annually distribute all personal holding company income;
2. Where the corporation is otherwise eligible, elect S-status.

Pursuit of the second option may be frustrated if the corporation has significant undistributed accumulated earnings and profits. Where it is not possible to distribute the accumulated earnings and profits prior to electing S-status, the S-election may automatically terminate due to excess passive investment income. (See the discussion of "Excess Passive Investment Income" below).

S-Corporation. As noted above, where an S-corporation is the settlor of a CRT, it should also be the income beneficiary of the CRT. As a result, the S-corporation should continue in existence for the duration of the term of the CRT. Distributions from the CRT should be paid directly to the S-corporation. The CRT will also issue a Schedule K-1 each year which will define the tax character of the CRT distributions received by the S-corporation. This information is then used by the S-corporation in preparing the Schedule K-1s issued to its shareholders. With respect to the CRT distributions, the tax character of S-corporation distributions to the shareholders should match (substantially) the tax character reported by the CRT to the S-corporation.

Dividends Received Deduction (C-Corporations)

Dividends reported to a C-corporation on a CRT Schedule K-1, may be eligible for the dividends received deduction of IRC §243.[123] Not all dividends are eligible for the deduction under IRC §243 nor are all dividends deductible to the same degree. The CRT trustee and/or administrator should provide sufficient detail on the Schedule K-1 issued to the C-corporation so that the corporation can substantiate the character of the dividends it receives from the CRT.

Gifts Of "Substantially All" Of the Assets Of a Corporation To a Charitable Organization

When considering the transfer of "substantially all"[124] of the assets of a corporation to a CRT, the non-recognition rules under IRC §337(d) should be reviewed. The regulations provide that when a corporation either converts to an exempt organization or contributes substantially all of its assets to an exempt organization, the transfer is treated as a deemed sale by the corporation immediately prior to the conversion or transfer.[125] The regulations specifically include CRTs in the list of exempt organizations for which this rule applies.[126]

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[121] See IRC §541.
[122] Personal holding company income is generally defined to include dividends, interest, rents, royalties, and annuities along with some other unusual items of income. See IRC §543(a).
[123] See PLR 8102093.
[124] The term "substantially all" is not defined in the Code or regulations. However, in Rev. Proc. 77-37, the IRS stated that for purposes of issuing an advance ruling, transfer of 90% of the fair market value of the net assets and 70% of the fair market value of the gross assets would constitute "substantially all."
[125] See Treas. Reg. §1.337(d)-4(a)(1) and (2).
[126] See Treas. Reg. §1.337(d)-4(c)(2)(ii).

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Some practitioners believe a case can be made that a corporation's retention of an annuity interest or unitrust interest in a CRT ameliorates the concern over the transfer of substantially all of its assets. For example, if a corporation creates a CRT and retains a unitrust interest valued at 85% of the contribution amount, then the argument is that the corporation has not transferred substantially all of its assets, but simply changed the form of its assets.

Application of Built-in Gains Tax (S-Corporations)

For S-corporations that were previously C-corporations, the IRC provides a special rule requiring the recognition of a corporate-level tax upon the sale of assets owned by the corporation at the time of conversion. This corporate-level tax is known as the "built-in gains tax," or BIG tax. The rule applies to sales that occur within a 10-year recognition period that begins on the date the corporation elects to convert to an S-corporation.[127]

The IRS has ruled that the transfer by an S-corporation to a CRT of property that would otherwise be subject to the BIG tax would not trigger recognition of the built-in gain, nor would the subsequent sale of the property by the trust cause the S-corporation to recognize the built-in gain.[128]

However, to the extent the trust would be required to distribute gain arising from the disposition of built-in gains property to satisfy the annuity or unitrust amount, the distributed built-in gains would be subject to the BIG tax at the S-corporation level for the remainder of the original 10-year recognition period.

Excess Passive Investment Income (S-Corporations)

If during three consecutive taxable years, an S-corporation has accumulated earnings and profits <u>and</u> receives more than 25% of its gross receipts from passive sources, then its S-election will automatically terminate.

The regulations provide that the earning and profits that count for this purpose must be derived from a period when the S-corporation was previously a C-corporation.[129] Therefore, this obstacle is not applicable to an S-corporation that never was a C-corporation <u>or</u> has distributed all of the earnings and profits earned while it was a C-corporation.

If an S-corporation has accumulated earnings and profits and chooses to create a CRT, it must either distribute the accumulated earnings and profits or <u>actively manage</u> the character of its gross receipts (including the CRT distributions) to remain below the 25% threshold. Failure to successfully navigate this obstacle will result in the loss of the S-election and the double taxation of at least the CRT distributions, if not other corporate earnings.

Passive investment income generally includes gross receipts derived from dividends, interest, rents, royalties, annuities, and capital gain.[130] Note that most CRT distributions are comprised of

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[127] See IRC §1374(d)(9).
[128] See PLR 200644013.
[129] See Treas. Reg. §1.1362-2(c)(3).
[130] See IRC §1362(d)(3)(C).

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these categories. Therefore, if there are undistributed earnings and profits, this is an important concern.

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Technique #4-Sale of Partnership Interest Through a CRT

Another technique that will occasionally be useful is the sale of a partnership interest through a CRT. Using a CRT to sell a partnership interest can help a donor meet personal financial and philanthropic goals.

> **Example:** Frank Newman, age 59, is a 30% partner in MNG Partners. The partnership was formed to hold and manage a portfolio of rental properties. Frank's partners (who are unrelated to Frank) have proposed to purchase Frank's interest in MNG Partners.
>
> MNG Partners is currently valued at $5 million. Frank's basis in his partnership interest is $600,000.
>
> Frank is interested in selling his partnership interest through a CRT because of a commitment to the local symphony. During the fact finding stage it is determined that three of the properties owned by MNG Partners are subject to mortgages totaling $200,000.
>
> Recognizing that the mortgages will create multiple problems for Frank's CRT plan, Frank negotiates a capital call prior to the transfer of his interest in MNG Partners to the CRT. The other partners have the means to supply the additional capital and are willing to do so in order to acquire Frank's interest.
>
> Frank transfers his 30% interest to a Flip-CRUT to minimize the risk associated with a delayed sale. The advisors are careful to ensure that the CRT's remainder interest must be paid to a public charity. Frank obtains a qualified appraisal of his 30% partnership interest in order to substantiate his charitable income tax deduction.
>
> As a result, the gain on the sale of Frank's partnership interest is sheltered from immediate taxation. Frank receives a current income tax deduction, a unitrust interest for life, and the value transferred to the CRT is removed from his taxable estate. At Frank's death, a significant gift will be made to the symphony.

Additional Considerations Unique To Partnerships

Pass-Through Of Unrelated Business Income

Trade or business income earned by a partnership is passed through to the partners and is treated as unrelated business income by a CRT. As described earlier, unrelated business taxable income earned by a CRT is subject to a 100% excise tax.

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Unrealized Ordinary Income Items

The value of the charitable deduction allowed for the contribution of a partnership interest is reduced by the sum of certain unrealized ordinary income items:[131]

- Unrealized trade receivables;
- Certain recapture items, such as depreciation recapture; and
- The excess of the value of inventory over its basis.

In addition, when a partnership interest is sold, the above items must be recognized and included in income as ordinary income.[132]

Sale of Partnership Interest Holding Encumbered Property

The IRS has considered whether the sale of a partnership interest by an exempt organization where the partnership owned encumbered property would be effective in avoiding the characterization of the gain in the encumbered property as unrelated debt-financed income (UDFI). In this circumstance, the IRS found that it is more appropriate to consider the partnership as an aggregate of its partners rather than as a separate entity—thereby effectively imputing the acquisition indebtedness of the underlying property to the partnership interest.[133] As a result, the sale of a partnership interest holding encumbered property is treated no differently than the sale of the underlying property followed by a distribution of the sale proceeds to each partner.

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[131] See IRC §170(e)(1)(A).
[132] See IRC §751.
[133] See TAM 9651001.

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Technique #5-Partnership Distributes Asset(s) To Partners; Partners Create CRT(s)

A CRT may be proposed when an asset owned by a partnership is to be sold. A preferred solution may be to distribute the asset in-kind to the partners prior to creating a CRT. If this is possible, each partner can then decide whether a CRT fits his or her charitable and financial planning goals. Additionally, a partner that elects to create a CRT is not limited to a fixed term, but rather can create a lifetime CRT.

> **Example:** Bob and Susan Conrad, age 55, are each a 50% partner and jointly the sole general partners of BSC Partners. They have been approached about the potential sale of a multi-unit apartment building owned by BSC Partners and valued at $1.5 million with a depreciated tax basis of $250,000. Bob and Susan are interested in using a CRT for its tax advantages and as a low-cost way to make a substantial gift to their local children's hospital.
>
> Bob and Susan have considered a 20-year term CRT, but given their relative youth have determined that a lifetime interest CRT is more consistent with their goals. In order to facilitate the creation of a lifetime interest CRT, BSC Partners distributes the building from the partnership to Bob and Susan individually. Deeds are drawn up and recorded evidencing this transfer.
>
> Bob and Susan's gift planning team then recommends that Bob and Susan transfer title of the apartment building to a CRT that will terminate at the death of the survivor. The CRT will be a flip charitable remainder unitrust designed to flip upon the sale of the property. Bob and Susan also obtain a qualified appraisal for their transfer of the apartment building to their CRT, in order to substantiate their charitable income tax deduction.
>
> Because Bob and Susan desire to obtain a full fair market value deduction for their contribution, their attorney is careful to ensure that the CRT's remainder interest must be paid to a public charity.
>
> As a result, the gain on the sale of the apartment building is sheltered from immediate taxation. Bob and Susan receive a current income tax deduction, a joint unitrust interest for their combined lifetimes, and the value of the apartment building is removed from their taxable estates. After the end of the trust's term, the children's hospital will receive a substantial gift.

Additional Considerations

Distributions Of Property To Partners

The transfer of property, other than money or marketable securities, to individual partners in proportion to their partnership interests generally will avoid the recognition of gain by the

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partner and partnership.[134] A partner's basis in property distributed in-kind is equal to her proportionate share of the partnership's basis in the property immediately prior to distribution.[135]

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[134] See IRC §731(a) and (b). For distributions of marketable securities, special rules apply under IRC §731(c).
[135] See IRC §732(a).

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Technique #6-Partnership Creates a CRT

A CRT may be proposed when an asset owned by a partnership is to be sold. While the preferred solution may be to distribute the asset to the partners as described in Technique #5, sometimes this option is not feasible. For example, the number of partners may make such a transfer costly and add significant complication to the subsequent sale of the asset. Therefore, it may be desirable for the partnership to create a CRT. The IRS has held that LLCs[136] and partnerships[137] are permissible settlors of a CRT.

> **Example:** Fred and Linda McCoy, are the general partners of McCoy Family Partners (MFP). They have been approached about the potential sale of 15 acres of prime development property owned by the partnership.
>
> Forming a CRT to sell the property is an attractive solution that will accomplish a number of the family's tax and philanthropic goals. However, there are currently 15 partners in the partnership. Transferring the property to the individual partners would necessitate the creation of multiple deeds, multiple qualified appraisals upon subsequent contribution to each partner's CRT, and the concurrence of all parties to accomplish the ultimate sale of the property. This is clearly more trouble than it's worth.
>
> Fred and Linda's gift planning team recommends that MFP transfer the property to a CRT created by MFP and of which MFP will be the sole income beneficiary. The CRT will be a flip charitable remainder unitrust designed to flip upon the sale of the property. The CRT will terminate at the end of 20 years. MFP also obtains a qualified appraisal for its transfer of the development property to a CRT, in order to substantiate its charitable income tax deduction.
>
> In keeping with the desire of the partners to obtain a full fair market value deduction, MFP's attorney is careful to ensure that the CRT's remainder interest must be paid to a public charity.
>
> As a result, the gain on the sale of the property is sheltered from immediate taxation. Each partner receives a current income tax deduction, a share of a unitrust interest for the next 20 years, and indirectly the value transferred to the CRT is removed from each partner's taxable estate. After the expiration of the 20-year term, the family's donor-advised fund will receive a substantial gift.

Additional Considerations Where a Partnership Is the Settlor of a CRT

Selection of the Income Beneficiary

The Code and the regulations permit any person[138] to be named as the income beneficiary of a CRT so long as at least one beneficiary is not a charitable organization.[139] When there is a valid

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[136] See PLR 199952071.
[137] See PLR 9419021.
[138] IRC §7701(a)(1) defines a "person" as an individual, trust, estate, association, company, corporation, and partnership.

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business purpose, it is possible to name someone other than the partnership as the income beneficiary of a CRT created by a partnership (e.g., one or more of the partners or a key employee).[140]

A second consequence of naming a person other than the partnership as the income beneficiary is that the partnership is treated as having made a constructive distribution.[141] Depending on the relationship of the individual to the partnership and/or its partners, this constructive distribution may be classified as compensation and/or a gift.

As a result, partnerships that create CRTs are advised to name themselves as the sole income beneficiary.

Selection of Trust Term

When a partnership is the sole income beneficiary of a CRT (as discussed in the previous section), the Code requires that the trust term be a term certain not to exceed 20 years.[142] While the maximum term is 20 years, consideration should be given to shorter terms. Often marrying shorter terms with higher payout rates will produce attractive results.

In certain cases, restrictions in the governing documents, the number and geographic dispersion of partners, the costs of re-titling assets to numerous parties, are factors that may limit the viability of in-kind distributions to partners.

Who Can Claim the Income Tax Deduction

As a pass-through entity, when a partnership contributes assets to a CRT, the resulting charitable deduction passes through to the partners in proportion to their partnership interest.[143]

As noted above, the type of charity selected as the remainder beneficiary of a CRT will affect the income tax deduction. Each partner must be provided sufficient information regarding the transaction to permit the partner to accurately apply the AGI limitations and reduction rule described under the section entitled “Deductibility of Contributions”. As a result, the Schedule K-1 provided to each partner should report both the fair market value, the adjusted tax basis of property contributed to a CRT, and the private foundation/public charity status of the permissible charitable recipient(s).[144]

Continued Existence of the Partnership

Where a partnership is the settlor of a CRT, it should also be the income beneficiary of the CRT. As a result the partnership should continue in existence for the duration of term of the CRT.

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[139] See IRC §664(d)(1)(A) and Treas. Reg. §1.664-2(a)(3)(1) for annuity trusts. See IRC §664(d)(2)(A) and Treas. Reg. §1.664-3(a)(3)(1) for unitrusts.
[140] A discussion of valid business purposes for creating a CRT that names an individual as an income beneficiary is beyond the scope of this paper. However, an example might include using a CRT as an alternative form of executive compensation.
[141] See Treas. Reg. §1.671-2(e)(4).
[142] See IRC §664(d)(1)(A) for annuity trusts and IRC §664(d)(2)(A) for unitrusts.
[143] See IRC §702(a)(4).
[144] See IRC §702(b).

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In this case, the CRT will issue a Schedule K-1 to the partnership each year which will define the tax character of the CRT distributions received by the partnership. This information is then used by the partnership in preparing the Schedule K-1s issued to its partners. With respect to the CRT distributions, the tax character of partnership distributions to the partners should match (substantially) the tax character reported by the CRT to the partnership.

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