Charitable Planning for Small Business Owners

Of the 4.6 million corporations in the U.S., small businesses outnumber large ones by 1,500 to one, making it likely that clients will have estate planning issues as they sell or transfer their interests. It also creates opportunities for clients to support charity with their closely held shares, or allow the gifts to come from their businesses. Here are a few ways small business owners and their companies can support Berkeley:

- Outright gifts of closely held stock - The majority shareholder of a C corporation may have a low basis in his or her shares, which could trigger capital gains and possibly the 3.8% net-investment income tax on a sale. The owner could, instead, give the shares to charity, which would seek to sell them. So long as charity is not required to sell the shares back to the company, the owner will not be considered to have received a dividend when the company redeems the shares [Revenue Ruling 78-197]. The result: the donor receives a charitable deduction on his or her personal return, although the funds came from the company.

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Chemist Yang Receives MacArthur Genius Award

Peidong Yang, 44, the S.K. and Angela Chan Distinguished Professor of Energy in the Department of Chemistry and a faculty scientist at Lawrence Berkeley National Laboratory, first achieved notice about 15 years ago when he was the first to build semiconductor nanowires and turn them into tiny lasers smaller than a human hair. He is currently involved in a large effort to develop a synthetic leaf that uses the principles of photosynthesis, whereby green plants capture light to turn carbon dioxide and water into sugars, to instead make useful chemicals, including fuels such as butane and methane. “Professor Yang is a world leader in the synthesis and growth of new classes of nanomaterials with useful properties that cannot be matched by conventional alternatives,” said Doug Clark, College of Chemistry dean. “Applications of innovations from the Yang laboratory range from producing chemicals and fuels from solar energy to creating smaller and more efficient electronic devices. The College of Chemistry is extremely pleased and proud that he has received this well-deserved recognition.”
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and charity receives a thoughtful gift. Donors need a qualified appraisal if the value of the gift is $10,000 or more [Reg. §1.170A-13(c)(2)(ii)(B)(1)].

- Receiving income from a gift of closely held stock - An owner can use C corporation shares to fund a charitable remainder trust, avoiding capital gains and the net investment income tax upon a sale by the trustee. Normally, a sale of shares back to the company would be an act of self-dealing, since the company is a disqualified person [Code §4941(d)(2)(F)], but an exception allows the company to offer to redeem, in cash, the stock of all shareholders at fair market value [Reg. §53.4941(d)-3(d)(1)].

In general, S corporation shares are not appropriate for life-income gifts. S shares used to fund a charitable remainder trust will cause the corporation to lose its S status. While charities are eligible S corporation shareholders [Code §1361(c)(6)], all income, loss, credit or deductions, along with any gain on the sale of the shares, is considered unrelated business income tax to the charity. An S corporation can be the donor of certain assets and can establish a term-of-years charitable remainder trust, however.

- Stock options - A closely held company can grant charity an option to purchase its shares at a particular price for a specified period of time. The corporation is entitled to a charitable deduction when the option is exercised. The deduction is the difference between the fair market value of the stock and the exercise price [Revenue Ruling 75-348].

- Gifts by companies - A corporation can make an outright gift to charity of assets, or can use assets to fund a charitable remainder trust that will pay income for a term of up to 20 years [Reg. §§1.664-2(a)(5), 1.664-3(a)(5)]. For example, a company with a parcel of vacant land that is no longer needed could transfer the land to a remainder trust and take a charitable deduction, turning an asset with a negative cash flow into a source of income, while also satisfying philanthropic goals.

- Gift and liquidation - The owner of closely held stock can avoid some capital gain if shares are contributed prior to the adoption of a plan of liquidation. This can also be an opportunity for the owner to fund a charitable remainder trust.

UC Berkeley Planning Pointer:

Year-End Options to Consider

There are some year-end alternatives to outright gifts of cash or appreciated securities clients may want to consider:

- Clients looking for a source of tax-free income may find a charitable gift annuity to be an attractive option. In addition to fixed payments for life, a significant portion of the annuity is tax-free return of principal for the annuitant's life expectancy. The charitable deduction is an added bonus.

- The loss on a sale of appreciated securities from capital gains tax can be as much as 23.8% for a client in the 39.6% tax bracket who is subject to the 3.8% net-investment income tax. But if the securities are used to fund a charitable remainder trust rather than sold, there will be no reduction from capital gains tax. The donor also receives a charitable deduction based in large part on his or her age.

While some high-income clients may be subject to cutbacks on itemized deductions, that doesn't mean they should forego year-end (continued on page 4)
High Payout, No Deduction

A year prior to his death in 2007, Arthur Schaefer established two net-income with make up charitable remainder unitrusts. Each trust paid to Schaefer for life and then to one of his two sons for life. The unitrusts were to make 11% and 10% payouts respectively. His estate did not claim a charitable deduction with relation to the unitrusts, but instead reduced the amount reported on Schedule G, Transfers During Decedent’s Life, on the Form 706, by the charitable portion. The IRS said the estate was not entitled to a charitable deduction because the actuarial value of charity’s remainder interest was not at least 10% of the value of the assets contributed to the trusts [Code §664(d)(2)(D)].

The estate argued that the trustee was required to distribute only the trust income each year, not the full 11% or 10%, except where the trustee is making up for prior years when less than the stated percentage was distributed [Code §664(d)(3)(B)]. The remainder interest should be valued using the $7520 rate, provided the rate is above 5% of the net fair market value of the assets, according to the estate. (The $7520 rate in effect for the month the trust was created was 5.2%.)

The IRS pointed to Revenue Ruling 72-395 and Revenue Procedure 2005-54, which hold that the remainder interest of a net-income with make up charitable remainder unitrust is to be valued using the fixed percentage, despite the fact that distributions are limited to net income.

The Tax Court, finding Code §664(e) to be ambiguous, turned to legislative history to ascertain Congressional intent. A report on the Senate amendment to the Tax Reform Act of 1969 stated that in valuing the charitable deduction, the remainder interest in a trust is to be determined on the basis that the income beneficiary will receive the “higher” of 5% or the payment provided in the trust. The payout rate set forth in the trust is to be used to value the remainder interest, said the court, even though distributions may be limited by net income (Estate of Schaefer v. Comm’r, 145 T.C. No. 4).

Tax Planning Pointer

The advantages of charitable gifts of appreciated stock held more than one year are well-known: avoidance of capital gains tax that would be due on a sale and a charitable deduction for the full fair market value of shares on the date of gift. But what if the client owns stock that has gone down in value? A better alternative is to sell the shares and donate the proceeds to charity, producing both a capital loss deduction and a charitable deduction.
Extrinsic Evidence Might Shed Light on Unambiguous Wills

Irving Duke prepared a holographic will in 1984, when he was age 72 and his wife was age 58. The will left all his property to his wife, but provided that if the two died in a common accident, his estate was to be split into two equal shares. One share would go to the City of Hope in memory of his sister, the other would go to the Jewish National Fund, to plant trees in Israel in memory of his parents. The will included an in terrorem clause limiting anyone seeking to invalidate the will to $1.

Duke did not update his will after his wife’s death in 2002. At Duke’s death in 2007, the two charities sought to have the will probated. Duke’s sole intestate heirs – two nephews – argued that because the will did not provide for the situation where Duke was the surviving spouse, his estate passed to them via intestacy. The probate court said the in terrorem clause did not apply, since the nephews were not challenging the validity of the will, but rather arguing that the will did not address the situation where Duke would survive his wife.

The charities sought to introduce extrinsic evidence showing that Duke intended his estate to pass to charities in the event his wife was not alive. The probate court said that because Duke’s will was unambiguous, no extrinsic evidence would be allowed to rewrite the document. This followed the California Supreme Court’s 1965 ruling in Estate of Barnes (63 Cal.2d 580).

The Supreme Court has reversed and remanded the probate court ruling (Radin v. Jewish National Fund, B227954), saying “the categorical bar on reformation of wills is not justified.” Wills can be reformed, the court ruled, provided there is “clear and convincing evidence” of a mistake at the time the will was written and of the testator’s actual specific intent.

Why the change from Barnes? The court noted that in the intervening years the state legislature has “codified judicial expansions of the admissibility of evidence with respect to a testator’s intent” and pointed to the “evolution of the law of probate and modern theories of interpretation of writings.” Extrinsic evidence is “generally admissible” to correct other types of documents, the court noted, adding that “evidentiary concerns do not explain or justify the bar on reformation of wills.” Denial of extrinsic evidence in the case of an unambiguous will “may result in unjust enrichment if there is a mistake of expression in the will” (Estate of Duke v. Jewish National Fund, S199435).

Year-End Options . . . (continued from page 2)

charitable gifts. The reduction is 3% of the amount by which 2015 AGI exceeds $258,250 (single taxpayers) or $309,900 (joint returns), up to a maximum of 80% of affected deductions. The vast majority of taxpayers subject to the reduction will have other, fixed deductions (such as mortgage interest, state income, and real estate taxes) that will likely more than absorb any reduction.

The following computation shows that, for most clients, other deductions already cover the 3% reduction, so charitable gifts should be 100% deductible.