Closely Held Stock to Remainder and Lead Trusts

A majority shareholder of a closely held corporation typically has a low basis in the shares, relative to their fair market value. Selling the shares to an individual or back to the corporation will trigger capital gains tax. However, a charitable contribution of the shares does not cause the realization of capital gain, and the donor can claim the fair market value of the shares on the date of the contribution as a charitable deduction. Often, however, the owner is not able to part entirely with the shares, or has other planning issues involving the company. The charitable remainder trust and the charitable lead trust could be options.

Charitable remainder trust

Consider a donor who owns 90% of the shares of a C corporation who wants to make a gift of $500,000 of the shares to a charitable remainder unitrust. The gift avoids capital gains tax on the transfer, provides unitrust payments for (continued on page 2)

Student Veterans Find Supportive Community at Berkeley

UC Berkeley is a national leader in serving returning service members and military affiliated students. Sources such as U.S. News & World Report hail Cal as one of the country’s top 15 best colleges for veterans in 2017. The Cal Veteran Services Center is dedicated to providing programs and services in support of the academic and personal success of student veterans. The Center increases student veteran enrollment, supports academic and co-curricular experiences, and facilitates preparation for goals beyond graduation. Additionally, veterans are provided with comprehensive services to maximize financial aid and VA benefits, holistic and academic counseling, and a highly engaged and successful community of fellow Cal veterans and alumni. With a 92% graduation rate, Cal veterans bring a great track record of hard work and public service to the campus community.

If you have a client interested in supporting student veterans on the Berkeley campus, please call our office at 800.200.0575 to learn more about the resources the Center provides to these incredible Bears who have served our country.
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life, and entitles the donor to a charitable deduction. Self-dealing on the redemption of the shares might seem to be a problem because the donor is a disqualified person with respect to the unitrust, but self-dealing can be avoided if the fair market value is paid for the stock, the corporation offers to redeem all other stock in the company at the same price offered to the trustee [Reg. §53.4941(d)-3(d)(1)], and the charity is not obligated to sell the stock back to the corporation. A donor who establishes a unitrust with closely held stock might consider a flip trust [Reg. §1.664-3(a)(1)(i)(c)(2)] if immediate redemption or sale of the stock is uncertain.

Charitable lead trust
Capital gains taxes may discourage gifts-followed-by-redemption to lifetime lead trusts, but a testamentary charitable lead trust poses no such problem because the stock receives a step-up in basis.

What if a lifetime charitable lead trust retains the gift stock? Retention works, provided the stock pays regular dividends. If that is the case, significant gift tax savings may be available. Retention also may work where the trust is structured as a grantor trust intended to provide the donor with both income tax deductions and gift tax deductions. The plan would involve a transfer of stock to a lead annuity or unitrust that pays income to charity, with the remainder passing to the donor's children. Stock is divided into two gifts – one charitable and one private – for transfer tax purposes, and the gift tax charitable deduction reduces the taxable gift to the children. Furthermore, some or all of the future appreciation can pass to the children free of federal transfer tax (note that capital gains taxes are still a problem when the children sell). Under Code §4947(b)(3)(A), the value of a gift to charity cannot exceed 60% of the value of the stock placed in trust.

UC Berkeley Planning Pointer:

Problem Solving with Charitable Gifts

Philanthropic clients receive personal satisfaction from helping worthwhile causes, but gift planning can also provide significant tax and financial rewards, and, in some cases, can be a solution to personal and family challenges.

- A donor wants to honor a late spouse while also assisting a sibling who has suffered financial setbacks. The donor can use highly appreciated stock to establish a charitable remainder trust that will make payments to the sibling for life, with the remainder passing to charity upon the sibling's death.
- A client with several small apartment buildings wants to get out of the landlord business, but knows that capital gains taxes will be owed on the depreciated properties if they are sold outright. Instead, the client can use the buildings to fund a charitable remainder trust that will generate a charitable deduction as well as payments for life (or a term of years), replacing the rental income that the client previously received.
- A client plans to name nieces and nephews as the beneficiaries of an IRA, but knows they will owe income tax on any distributions. The client could name charity as the beneficiary, conditioned on the organization establishing a deferred payment charitable gift annuity for each niece and nephew, with payments beginning as they reach age 60. Payout rates for the gift annuities will be higher because of the deferral.
Two days after the creation of NHP, a limited partnership, a son transferred assets worth $10 million from his mother’s revocable trust to NHP in exchange for a 99% limited partnership interest. The same day, the son, purportedly acting under a power of attorney, assigned the mother’s revocable trust interest in NHP to a charitable lead annuity trust. The lead trust was to make payments to a private foundation for the mother’s life before assets were divided between the son and his brother following the mother’s death. The mother died one week later.

The mother’s 2008 gift tax return reported a taxable gift of $1,661,422 for the remainder interest in the lead trust. The IRS determined that because the mother was terminally ill when the lead trust was funded, the remainder interest was worth $8,363,095. The IRS also determined that the mother’s gross estate included the full $10 million under either Code §2036(a) or Code §2038(a), because she retained the right to the income or to change the enjoyment through an exercise of a power. The bona fide sale exception to Code §2036(a) does not apply, said the IRS, because the estate showed no significant nontax purpose for the creation of NHP.

The estate argued that if the mother retained an interest in NHP, she did not retain that right for the remainder of her life because she transferred the partnership interest to the lead trust. Therefore, the estate claimed, Code §2036(a)(2) does not apply to the transfer of cash and securities to NHP. The Tax Court found the estate’s argument unpersuasive, notig that under California law, the transfer to the lead trust of the 99% partnership interest was either void or revocable because the son lacked the authority to make gifts in excess of the gift tax exclusion amount. Further, because the transfer occurred within three years of death, the value would be included in the gross estate under Code §2035(a).

The estate did not challenge the IRS’s contention that the son had no “legitimate and significant nontax reason” for creating NHP. Therefore, said the court, the transfer of cash and securities was not a bona fide sale for adequate and full consideration. Because the gift exceeded the son’s authority under the power of attorney, under California law it was either void or revocable. If void, the value of the limited partner interest on the date of death would be included in the mother’s estate under Code §2033. If revocable, the value would be included under Code §2038(a).

Under California law, an attorney-in-fact does not have the authority to make gifts unless expressly provided in the power of attorney. The son’s power of attorney allowed him to make gifts only to specified donees and only to the extent of the federal annual gift tax exclusion. The estate claimed that even without the authority, the gift to the lead trust was valid under the ratification provision of the power of attorney. The court disagreed, noting that California courts have held that a general grant of authority to convey property does not provide the power to make gifts. To hold otherwise, said the court, “would render meaningless any limitations or restrictions on the authorized powers.” Because the gift to the lead trust was either void or revocable, the court held that the estate was not liable for the gift tax deficiency (Estate of Nancy Powell, 148 T.C. No. 18).
Retaining the Right to Revoke Payments to Beneficiaries and Annuitants

Charitable remainder trusts and charitable gift annuities can be used to provide payments to more than just the donor. When payments are made to the donor, or to the donor and spouse, there is no gift tax concern, but where a parent, child, sibling or other person is also receiving a portion of the payment, gift tax issues may arise. Although lifetime gifts up to $5.49 million are sheltered from tax, clients may wish to avoid the necessity of filing gift tax returns for these gifts. One way to bypass the gift tax issue is to retain the right to revoke the beneficiary’s interest, making the gift incomplete [Reg §25.2511-2(c)].

Charitable remainder trusts

A charitable remainder trust may not be subject to a power to invade, alter, amend or revoke for the beneficial use of a person other than a charity. However, the grantor may retain the power, exercisable only by will, to revoke the interest of any beneficiary of the annuity or unitrust amount [Reg. §§1.664-2(a)(4), 1.664-3(a)(4)].

By retaining such a power, the grantor may avoid any gift tax liability for the value of the rights in the trust that are transferred to another. Any payments actually received from the trust during the grantor’s lifetime generally will be treated as completed gifts to the extent they exceed the annual exclusion. Retaining the right to revoke has no effect on the charitable deduction.

A grantor may also want to retain the right to revoke a successor beneficiary’s interest, particularly since it is a future interest that does not qualify for the annual exclusion when the trust is created. A donor concerned about whether he or she will still be married at death may want to retain the right to revoke the spouse’s survivor interest in the event the couple divorces, particularly since the estate tax marital deduction would not be available.

Although the charitable remainder may not be revoked, the donor may reserve the power to substitute another charity [Rev. Rul. 76-8].

Charitable gift annuities

An individual who arranges a gift annuity for another can avoid making a taxable gift by retaining the power to revoke the interest of the annuitant, making the gift incomplete. Completed gifts occur only as payments are actually received by the annuitant during the donor’s life. Unlike charitable remainder trusts, the right to revoke an annuitant’s interest may be exercised during life or at death. Donors who establish two-life gift annuities can retain the right to revoke the successor annuitant’s interest.