



The Wealth Counselor

A monthly newsletter for wealth planning professionals

Business Exit Planning Using Charitable Strategies

Volume 5, Issue 10

Business owners usually have four goals when they leave their businesses: retire from the business; sell to a new owner (family members, employees, or third parties); minimize taxes and maximize profits. For those who are already charitably inclined, business exit planning using charitable tools allows them to add a fifth goal: doing good things for their favorite charity or their community.

In this issue of *The Wealth Counselor*, we continue our series on business exit planning by examining some frequently used charitable planning tools and some common pitfalls.

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Wealth management is so much more than wills and trusts or contracts. At the Fisher Law Office, our life's work is helping clients with their life's work, understanding each client's needs and concerns for the future and helping them plan for themselves and loved ones. Regardless of your client's needs, our office is ready to assist you help them.

Tools for Business Exit Planning Involving Charitable Giving

Three tools involving charities are typically used in business exit planning: charitable remainder trusts, gift annuities and charitable lead trusts.

A **charitable remainder trust (CRT)** is a tax-exempt trust. It is primarily an income tax planning tool with some estate and gift tax benefits. With a CRT, the appreciation in assets can be realized without immediate gain recognition tax-free, a stream of payments created for the donor and a deferred benefit provided to a charity. An income tax deduction, gift tax deduction or estate tax deduction is based on the remainder value that passes or is projected to pass to charity at the end of the trust term. Certain private foundation rules apply, which can be problematic.

A **gift annuity** is essentially a bargain sale in which the consideration paid by the charity is in the form of annuity payments. Code Section 72 specifies how the income is categorized; i.e., how much is return of principal and how much is ordinary income. Code Section 1011 specifies how gains are recognized, for example if the gift annuity is funded by contribution of appreciated assets. Code Section 415 limits payments to one or two persons. Private foundation rules do not apply to gift annuities.

A **charitable lead trust (CLT)** is the opposite of a charitable remainder trust in that the income stream is paid to charity with the remainder going to private individuals. A CLT is primarily an estate or gift tax tool. If it is set up as a grantor trust, it can also provide some income tax benefits. Unlike a CRT, a CLT is not a tax-exempt trust. Some private foundation rules apply to CLTs.

Business Succession Pitfalls

When trying to do charitable planning in conjunction with business exit planning, there are three potential pitfalls: having the transaction treated as a prearranged sale, the unrelated business taxable income (UBTI) rules, and the rule against self-dealing, which is one of the private foundation rules.

Prearranged Sales

Most business owners want a high degree of control, especially when it comes to selling their business. Often they will want to negotiate the sale, execute a binding sale contract, and then transfer the property subject to the sale obligation. That will not work because it violates the prearranged sale rule. Violating that rule means that the IRS will treat the donation as but one step in a unified transaction. Revenue Ruling 78-197 provides:

[The IRS] will treat proceeds of a redemption of stock...as income to the donor only if the donee (charity) is legally bound or compelled by the corporation to surrender the shares for redemption.

(Emphasis added.) Under Rev. Rul. 78-197, the key then is whether the charity (or the Trustee of the CRT or CLT) is *obligated* to sell the donated property to the buyer that the donor has identified.

If the donor violates the prearranged sale rule, the sale proceeds will be income to the donor and the donor will not avoid recognizing the capital gains on the sale.

Planning Tip: The donor can identify and let potential buyers know that the business is for sale and even negotiate a sale price as long as the charity or Trustee is not *obligated* to go through with that sale.

Unrelated Business Taxable Income (UBTI)

All tax-exempt organizations and charitable trusts are subject to tax on UBTI. UBTI is income from a trade or business that is owned and regularly carried on by a charity or charitable trust that is not substantially related to the tax-exempt function of the charity.

Exceptions include dividends, interest, annuities, royalties, certain rents from real and personal property and capital gains - unless they are derived from debt-financed property.

Income from debt-financed property is UBTI regardless of whether the organization is actually engaged in a trade or business. Debt-financed property is any property held to produce income and with respect to which there is acquisition indebtedness. Acquisition indebtedness generally means indebtedness incurred when acquiring or improving the property.

A charity has acquisition indebtedness when it acquires property (by a gift or purchase) that is subject to debt or borrows against the property to make improvements. Property is considered "debt-financed" even when the charity or trust acquires the property "subject to" the debt.

There are, however, a couple of exceptions:

- An organization will not recognize UBTI solely because the property is debt-financed property for 10 years after receipt if the transfer occurs because of the donor's death.
- Lifetime gifts are not considered "debt financed" if three conditions are met: the organization does not assume the debt, the donor had owned the property for more than five years at the time of the contribution, *and* the debt had existed on the property for more than five years at the time of the contribution.

The Income Tax Impact of UBTI

A charity, including one with gift annuities, must pay tax on all of the UBTI it receives.

For CRTs, any UBTI is confiscated through a 100% excise tax. (The rule used to be different - that if a CRT received any UBTI in a year, all of its income for that year was treated as UBTI.)

For CLTs, when it makes a distribution of the unitrust or annuity amount to the charity, it takes a 100% deduction. However, if the CLT has UBTI, this deduction drops to 50% if paid to a public charity and to 0% if paid to a private foundation.

Self-Dealing

Code Section 4941 lists six specific acts of self-dealing for a private foundation:

1. The sale, exchange or leasing of property between a disqualified person and the foundation, regardless of the size of the transaction;
2. Loans of money or any other extension of credit between a disqualified person and the foundation;
3. The furnishings of goods, services or facilities between a disqualified person and the foundation;
4. The payment of compensation or reimbursement of expenses by the foundation to a disqualified person;
5. The transfer of income or an asset from the foundation to a disqualified person for the disqualified person's use or benefit; and
6. An agreement by the foundation to pay a government official, other than an agreement to employ the official for any period after the termination of

his government service, if the official terminates his government service within a 90-day period.

Disqualified persons (also defined in Section 4941) are the donor; the trustee; family members (which include the grantor's spouse, ancestors, children, grandchildren, great-grandchildren and the spouses of these individuals); and controlled business organizations (those in which 35% or more of the ownership interest is controlled by disqualified persons).

The tax code makes the private foundation self-dealing rules applicable to CRTs and CLTs. This essentially prohibits *all* transactions between a CRT or CLT and the donor (and the donor's family) and any business in which the donor and his family have a 35% or greater ownership interest.

Planning Tip: Charities are not disqualified persons, so the remainder charity could purchase something from the trust and that would not cause a self-dealing problem.

Planning Tip: Self-dealing does not apply to transactions involving gift annuities that are maintained only by public charities. This makes gift annuities an important planning tool in business succession planning.

Conclusion

Incorporating charitable planning tools in business exit planning provides unique opportunities for the business owner who is already interested in charitable giving, as well as providing excellent opportunities for the professional advisors to work together.

To comply with the U.S. Treasury regulations, we must inform you that (i) any U.S. federal tax advice contained in this newsletter was not intended or written to be used, and cannot be used, by any person for the purpose of avoiding U.S. federal tax penalties that may be imposed on such person and (ii) each taxpayer should seek advice from their tax adviser based on the taxpayer's particular circumstances.

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