TECHNIQUES
An income, estate, and gift tax service for attorneys and other professional advisors

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Charting a Course for Success: Navigating a Charitable Gift of a Business Interest

For ancient mariners, sailing across the Mediterranean to northern Egypt became more treacherous as they approached the coast. Homer noted in *The Odyssey* that the coast of Egypt consisted of a broad delta and endless deserts, with very few landmarks by which to navigate. To help remedy this situation, Ptolemy, a general under Alexander the Great who ruled Egypt and eventually named himself Pharaoh, commissioned a lighthouse on the Isle of Pharos around 280 BCE. When Ptolemy’s son finished the project a few decades later, the Lighthouse of Alexandria not only guided sailors to the safety of port, it was also hailed as one of the Seven Wonders of the Ancient World and stood for 1600 years.

For modern-day taxpayers and donors, navigating the world of the Internal Revenue Code (IRC) can likewise prove treacherous for those who are unaware of hidden “shoals” and stray outside of the “navigable waterways” of allowed taxable transactions. This is especially true when dealing with charitable gifts of business interests. While final decisions rest with the taxpayer/donor, professional advisors play the role of the lighthouse, guiding the donor through the potentially dangerous waters of a charitable donation of a business interest, shining a light on potential hazards, and helping the donor set a course for success.

This issue of *Techniques* looks at questions that might arise when a donor is considering making a gift of a business interest.

Illuminating Potential Difficulties

While owners of S corporations, LLCs, and certain limited partnerships can donate a business interest, these donations are more complex and need significant legal and tax planning. Rather than attempting to address the particulars necessary to differentiate among the various types of business entities, the information presented here will strictly apply to a gift of a basic closely held C corporation. However, whichever form of business entity a donor wishes to give, it is critical that they seek the advice of legal and tax advisors and initiate discussions with the charity itself.

Why donate a business interest?

Someone who starts and builds a business typically views it as more than just a source of income—it becomes their passion and takes on emotional meaning. However, at some point, the owner must begin considering what their life will be like after the business. Some owners intend to pass all or part of the business to family members. Some simply want to get as...
much money out of a sale as they can. And others have a charity that is meaningful to them and love the idea of giving their business a second life in the service of that cause or organization. Such a donation would give them a great deal of satisfaction as they see their business passion continue to benefit others.

Successful business owners who are entertaining the idea of donating their business often turn to professionals for guidance and information. The remaining questions seek to illuminate important information that potential donors need and that professionals can provide.

Why donate the business interest itself instead of selling the interest and donating the proceeds?
This threshold question may well be first on the donor’s list. The short answer is that while cash donations are simple and straightforward, providing immediate satisfaction, cash is rarely the most tax-effective gift option. In fact, the direct donation of a business interest comes with an added tax benefit that makes it an idea worth considering.

Qualify for a charitable income tax deduction. Most donors are aware of the long-standing public policy under which Congress encourages taxpayers to support qualified charities by allowing charitable donations to qualify for a deduction on the donor’s federal income tax return if the donor itemizes. In IRC §170, the Code allows (subject to restrictions) “as a deduction any charitable contribution … payment of which is made within the taxable year.” Like cash, property, and many other gifts, the donation of a business interest may qualify for a federal income tax charitable deduction.

Minimize or bypass capital gains taxes. A capital gain is the amount by which an asset’s sale price exceeds its purchase price or “basis.” (Of course, basis generally also includes any additional costs, such as commissions and recording or transfer fees, and may be adjusted over
time to reflect other factors such as improvements or depreciation.) If the business interest has appreciated in value, a sale will trigger the assessment of capital gains tax. However, no capital gains tax is imposed on a charitable donation of appreciated property. This can be significantly beneficial to the owner who is looking to get rid of a business interest—particularly since an owner’s basis is often very low or even zero. In that case, minimizing or even bypassing any capital gains tax (while still qualifying for a tax deduction for the full amount) becomes extremely attractive.

**Is there a limit to the amount a donor may deduct?**

Yes. The donor can take an itemized charitable income tax deduction in the year of the contribution, but the deduction is limited to a percentage of the donor’s adjusted gross income (AGI) for that tax year. (The percentage limits do not apply to the gift or estate tax charitable deduction.) The general rule for contributions “to” 50% charities (discussed below) is that a taxpayer’s deduction for charitable gifts may not exceed 50% (60% for cash) of the donor’s “contribution base” (AGI without NOL) for the year and 30% of AGI for non-cash capital gain gifts using FMV without reduction for appreciation. If the donor cannot use the entire deduction amount in the first year, any excess can be carried over for up to five subsequent years.

**Does the type of charity matter?**

Yes. As the nexus between philanthropic planning and tax planning, the income tax charitable deduction is a key consideration when a donor is exploring a gift of a business interest. Therefore, it is important to ensure that the donor’s preferred charity is eligible to accept the donation and is able to provide the donor with an income tax deduction under IRC §170(c).

Not every charitable contribution will be deductible in the same way for income tax purposes since the IRC identifies some qualified charities for a larger deductible amount than others. There are several distinctions to draw between the deductibility of contributions made to a 50% organization as opposed to a 30% organization.

A gift to a 50% organization is deductible up to the taxpayer’s applicable limitations. A 50% organization is one of the qualified charities expressly described under IRC §170(b)(1)(A), which includes:

- churches
- hospitals and medical research organizations
- educational organizations
- governmental units
- publicly supported charities
- certain private foundations
- supporting organizations

A gift to a 30% organization is deductible up to 30% of the donor’s AGI. A 30% organization refers to all qualified charities not described under
IRC §170(b)(1)(A)—generally speaking, this would be a private foundation as defined under IRC §509(a).

**Are there any restrictions on the transfer of the ownership of the business entity?**
Possibly. Many businesses have incorporated restrictions in the entity documents, which limit how ownership of the business may be transferred. Restrictions that prohibit the transfer or sale of an interest in the company may be imposed through an existing shareholder or member agreement, a buy-sell agreement with other owners, a loan agreement, or some other creditor agreement. If restrictions do limit transfers, the donor’s legal counsel will need to review the document(s) imposing the restrictions and provide guidance as to how to proceed.

**Do any business assets present special issues or require additional review?**
Yes. For example, before a gift is completed, some businesses may need to:

- Conduct a Phase I or Phase II environmental report on business-owned real property
- Ensure that the corporation’s assets, both real and tangible, are free of liens with issues
- Ensure there are no clouds on the title to real property
- Ensure there is no pending litigation (or known potential claims) against the corporation

**Are there any statutory or regulatory issues to consider?**
Possibly. If a business operates in a highly regulated environment, it is important that the donor’s legal counsel review all applicable statutes, regulations, and ordinances to confirm that there are no obstacles to any such transfer of ownership.

**Does the owner wish to retain an interest in any part of the business interest to be donated?**
If the owner would like to retain an interest in the donated business interest, this will present additional challenges. While a donor generally must transfer the entire interest in a gift to a qualified charity to obtain a charitable deduction, a number of partial-interest gifts are allowed. IRC §170(f)(3)(A) provides that:

In the case of a contribution (not made by a transfer in trust) of an interest in property which consists of less than the taxpayer’s entire interest in such property, a deduction shall be allowed under this section only to the extent that the value of the interest contributed would be allowable as a deduction under this section if such interest had been transferred in trust. For purposes of this subparagraph, a contribution by a taxpayer of the right to use property shall be treated as a contribution of less than the taxpayer’s entire interest in such property.

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**IRS Database of Qualified Charities**
The IRS offers tools to help identify qualified charities, including a searchable database located on the IRS website.

To take a deduction, the donor must irrevocably transfer the entire interest as a gift to a qualified charity and may not continue to control the donated property. A gift of a partial interest generally does not qualify for a deduction.7 However, consider whether one of the three exceptions for gifts of a partial interest might apply:

1. a contribution of a remainder interest in a personal residence or farm
2. a contribution of an undivided portion of the taxpayer’s entire interest in the property
3. a qualified conservation contribution8

Assuming the donation takes place, what is the value of the gift?

Determining the gift’s value is often complex. It first requires the donor to value the business interest. To do this, it is essential to thoroughly understand the IRC valuation rules and gift substantiation requirements.

Fair market value. Generally, a business property interest owned by the donor for longer than one year is valued at its fair market value (FMV)—the price at which the property would change hands between a willing buyer and a willing seller, neither being under a compulsion to buy or to sell, and both having reasonable knowledge of the relevant facts.9

Gift substantiation. In order for the donor to claim a charitable deduction for a non-cash donation valued at more than $5,000, the charity must acknowledge, contemporaneous with the gift and in writing, the following information:

- A description of the donated property
- A statement of any goods or services the charity provides in consideration, including a description and good faith estimate of the value of such goods or services
• A statement, if applicable, of whether the charity provides any intangible religious benefits\(^{10}\)

• The manner and approximate date of acquisition of the property or, if the property was created or produced by the donor, the approximate date the property was substantially completed

• The adjusted basis of the property (other than publicly traded securities) held by the donor for less than 12 months immediately preceding the date of the gifts and, when the information is available, the adjusted basis of the property (other than publicly traded securities) held for 12 months or more\(^{11}\)

**Qualified appraisals.** In addition, the donor must obtain a “qualified appraisal” within the meaning of IRC §170(f)(11)(E). Under Reg. §1.170A-13(c)(3), a qualified appraisal is an appraisal document that:

• Relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property and not later than the due date (including extensions) of the return on which a deduction is first claimed under IRC §170

• Is prepared, signed, and dated by a qualified appraiser

• Includes a description of the property appraised, the fair market value of the property on the date of contribution and the specific basis for the valuation, a statement that such appraisal was prepared for income tax purposes, plus an attribution of the qualifications of the appraiser as well as the signature and taxpayer identification number of such appraiser

• States that the appraisal did not involve an appraisal fee that violates certain prescribed rules

As indicated above, any qualified appraisal must be conducted by a qualified appraiser in accordance with generally accepted appraisal standards and should assess value as of the proposed date of the gift.\(^{12}\)

Further technical requirements for meeting this IRC section are outlined by Treas. Reg. §1.170A-13(c). These guidelines will be considered satisfied if the appraisal is consistent with the substance and principles of the Uniform Standards of Professional Appraisal Practice (USPAP), as developed by the Appraisal Standards Board of the Appraisal Foundation. Given the potential complexity of valuing a business interest, donors should consider choosing an appraiser who is a member of a professional organization such as the American Society of Appraisers, the Institute of Business Appraisers, or the National Association of Certified Valuation Analysts.

In all cases, the donor must attach a fully completed appraisal summary to the applicable tax return on which the deduction for the contribution is first claimed (or reported) by the donor.\(^{13}\) In addition, the donor must maintain adequate records containing the information required by the applicable regulations.\(^{14}\)
The IRS provided additional information on qualified appraisers and qualified appraisals in Notice 2006-96, including comments on substantial and gross valuation misstatements attributable to incorrect appraisals.\textsuperscript{15}

### A Court Case Pertinent to Qualified Appraisals

The requirements for documenting a qualified appraisal are strictly construed. In *Hendrix v. U.S.*, the plaintiffs sought to take a charitable deduction of $287,400 and submitted an appraisal with the appropriate tax return.\textsuperscript{16} However, the IRS disallowed the deduction and assessed a $100,590 deficiency instead.

Ultimately the case came before the U.S. District Court Eastern District of Ohio. The plaintiffs failed to obtain the required contemporaneous written acknowledgments from the charity and did not submit a “qualified appraisal.” The court discussed the appraisal issue, noting that the plaintiff’s appraisal did not “contain the expected date of contribution, the terms of the agreement between Plaintiffs and the city, the qualification of Plaintiffs’ appraiser (including the appraiser’s background, experience, education, and any membership in professional appraisal associations), and the required statement that the appraisal was prepared for income tax purposes.”\textsuperscript{17}

While the plaintiffs argued they had substantially complied, the court disagreed: “(t)he issues are what Plaintiffs were required to do and submit as part of the deduction process and what they actually did, not what they could have done or what wishfully reparative steps they have taken years after the fact.”\textsuperscript{18} Based on this, the court found in favor of the IRS.\textsuperscript{19}

### Can a donor-advised fund (DAF) accept a donation of a business interest?

Yes. Donor-advised funds are charities under IRC §501(c)(3) and may accept a donation of a business interest. A DAF is a contractual relationship between the donor and a sponsoring organization.\textsuperscript{20} The donor makes a charitable contribution to the sponsoring organization, which then owns the assets and administers the fund. The donor retains advisory privileges over the charitable funds distributed from the account.

A donor-advised fund offers unique versatility in allowing a donor to give the business interest now, qualify for an immediate charitable income tax deduction for the amount of the contribution, then recommend specific grants later at a time that works best for the donor. All the requirements and guidance about the charitable donation must be followed for the donation to be eligible for tax benefits.
Does the charity face any issues when accepting a donated business interest?

Yes—there are certainly items for the charity to consider before accepting a contribution of a business interest. A significant item is any possible unrelated business taxable income (UBTI) that may result from the gift.

While income generated by a charity is usually tax exempt, under IRC §511, income from activities not in line with the organization’s charitable purpose is likely taxable. UBTI is income from a trade or business regularly carried on by the exempt organization where the business activities do not substantially relate (i.e., are “unrelated”) to the purpose for which the organization was granted tax-exempt status. The IRS states:

To determine if a business activity is substantially related requires examining the relationship between the activities that generate income and the accomplishment of the organization’s exempt purpose. Trade or business is related to exempt purposes, in the statutory sense, only when the conduct of the business activities has causal relationship to achieving exempt purposes (other than through the production of income). The causal relationship must be substantial. The activities that generate the income must contribute importantly to accomplishing the organization’s exempt purposes to be substantially related.21

For activities that are not substantially related, even though the production of funds directly impacts the charitable purpose, it will be necessary to review the facts and circumstances of the activities to determine whether the activity “contributes importantly.”

The IRC identifies certain activities that are excluded from the definition of unrelated trade or business, including volunteer labor, any trade or business carried on for the convenience of members, the sale of donated merchandise, and certain bingo games and other gaming activities.22

While UBTI is likely a non-issue for the donor of a business interest, it can be a big issue for the charity. In fact, the UBTI provisions of the IRC may cause the charity to consider the gift very carefully before accepting it or, in some cases, even reject the gift outright.

- The charity must understand any associated tax obligation (at the corporate income tax rate of 21% or higher if some of the proposed increases become law).
- The charity must be sure the gift of the business interest will not cause a loss of tax-exempt status, which is a risk if the organization engages in more than an insubstantial amount of unrelated business activity. Unfortunately, neither the IRC nor the IRS have clearly defined “more than an insubstantial amount” of UBTI.
What if a third party would like to buy the business interest?
This is a very common scenario when an owner wants to donate a business interest to a charity. In most cases, the charity does not want to actually own a business that is not part of its standard operations but instead wants to sell the business interest and use the proceeds for its charitable purpose.

To avoid issues with the donation, including the assessment of capital gains tax, there may not be any pre-arranged sale or pre-existing obligation for the purchase of the interest before the donation. If such an obligation exists, the donation may be subject to the assignment of income doctrine, which provides that income is taxed at the source to whoever earned it and may not be assigned to another party. It is very important for the donor to work with counsel and the charity to structure the gift correctly.

Lighting the Way to Success
Despite being a wonder of the ancient world, the Lighthouse of Alexandria ultimately collapsed centuries ago due to a combination of natural disasters and lack of proper upkeep. Since its rediscovery in 1968, underwater explorers have cataloged thousands of pieces of the lighthouse and related relics. The Egyptian government plans to develop the site into an underwater museum that would allow a glimpse of the fallen wonder.

Similarly, for financial professionals, illuminating a path for business owners to safely and strategically donate a business interest is not a one-off event. Circumstances change, and even tried-and-true methods are not immune to the passage of time. A sound charitable gift strategy requires regular maintenance and upkeep to ensure it remains in line with the IRC, tax law updates, and the ever-changing needs of the donor.

Endnotes
4 IRC §170(a).
5 IRC §170(b)(1)(A)(vi). There are two tests to determine if a charity normally receives a substantial part of its support from governmental units and/or contributions from the general public. Meeting either test qualifies the charity. One, the charity normally receives at least one-third of its total support from governmental units and/or the general public. And two, if the support from governmental units and the general public is at least 10% of the organization’s total support, and the charity is organized...
and operated so as to attract new and additional support from the government and the general public, and the charity can show a substantial degree of public support by various sources of support, the breadth of interests represented by the governing body, and the availability of public facilities and services.

6 IRC §170(f).
7 IRC §170(f)(3).
8 IRC §170(f)(3)(B).
9 Treas. Reg. §20.2031-1(b); IRC §2701.
10 IRC §170(f)(8)(A).
17 Id. at 10.
18 Id. at 15.
19 Id. at 22.
20 IRC §4966 describes a donor-advised fund by documenting three important requirements:

1. **Separate identification.** The first requirement, that the fund be “separately identified by reference to contributions of a donor or donors,” means the fund must be sequestered from the sponsor’s general fund and specifically identified by reference to a particular donor (or group of donors) in that all contributions must be attributable to the named donor (or group). The IRS clarifies: “A distinct fund or account of a sponsoring organization does not meet this prong of the definition unless the fund or account refers to contributions of a donor or donors, such as by naming the fund after a donor, or by treating a fund on the books of the sponsoring organization as attributable to funds contributed by a specific donor or donors.”

2. **Ownership and control.** The second requirement states that the fund or account must be “owned and controlled by a sponsoring organization.” Under this section of the Code, “sponsoring organization” is defined as a public charity (not a private foundation) that has one or more donor-advised funds. Typically, a sponsoring organization will either be a community foundation, a single-issue organization, or a national organization.

3. **Advisory privileges.** The third requirement states that the “donor (or any person appointed or designated by such donor) has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in such fund or account by reason of the donor’s status as a donor.” These advisory privileges may be (but are not required to be) evidenced through a written document executed by the donor and the sponsoring organization. If the sponsoring organization and the donor both conduct themselves as if the donor has advisory privileges, this may be enough to establish the privilege.

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