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Futures

A no-nonsense newsletter from The Dayton Foundation for estate planners and financial advisors

Corporate Stock: A Smart Way to Give Under the New Tax Laws

By Sam Warwar, Esq., Tax Partner, Coolidge Wall Co., L.P.A.

Most likely you've heard of Facebook founder Mark Zuckerberg, and the charitable foundation he and his wife started with a donation of 18 million shares of appreciated Facebook stock. Not many people may realize, however, that his foundation is a Donor-Advised Fund at a California-based community foundation. We have a similar foundation in the Dayton Region called The Dayton Foundation.

"If your client owns an S corporation or LLC rather than a C corporation, the tax rules are different. There also are pitfalls that both the client and the charity need to consider."
– Sam Warwar

If you have clients who own a closely held business, they may ask you if this is an option for them either now, while they own and operate the company, or prior to the sale of their business. Closely held stock can be donated to a charity. However, if your client does not own a traditional C corporation but, rather, an S corporation or LLC, there are some tax considerations that should be reviewed.

C Corporation

Generally, a charitable contribution of appreciated property enables your client to deduct the fair market value of the property without having to report the appreciation as income. This allows for entrepreneurs to contribute shares of their C corporation to a charity and obtain a deduction for the fair market value, and the charity can continue to own the stock, as Zuckerberg has done. This arrangement can work very well when the sale of the C corporation is anticipated to happen after the contribution, compared to selling the corporation and then making the gift to charity. Let's look at an example.

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Assume your client owns a C corporation with a business value of $7,000,000, a cost basis of $3,000,000 and desires to make a gift of $1,881,460. If the client makes the gift after selling the corporation, the client will recognize a $4,000,000 gain on the sale of the business, resulting in tax of $952,000 (using a 23.8% tax rate). The $1,881,460 gift will generate a deduction that will save your client $696,140 in taxes (based on a 37% ordinary income tax rate). Ultimately, your client will net $4,862,680.

If the gift is made prior to selling the corporation, then your client will recognize a $2,924,880 gain, resulting in taxes of $696,121. Now, the $696,140 tax savings from the gift will completely offset the tax from the sale of the corporation. Thus, your client will net $5,118,559 under this scenario.

As illustrated, the income tax savings of a gift prior to the sale are significant – approximately $255,000.

S Corporation and LLCs

If your client owns an S corporation or LLC rather than a C corporation, the tax rules are different. There also are pitfalls that both the client and the charity need to consider.

Donor's Perspective: Making a Gift of S Corporation Stock or Membership Interest of an LLC

A donor's income tax deduction for a donation of stock in an S corporation or a membership interest in a limited liability company that is taxed as a partnership (an "LLC")* usually will be less than the deduction available to a donor of C corporation stock. By way of background, the income tax deduction for a gift of appreciated property generally must be reduced by the amount of ordinary income that the donor would have had if the donor had sold the property. The rule generally does not apply to property that, if sold, would produce a long-term capital gain, like a sale of C corporation stock. That is why wealthy donors often favor gifts of appreciated stock and real estate without debt. They can deduct the full appreciated value without recognizing any taxable income from the growth in value that has occurred while they owned the property. If a gift consists of both long-term capital gain and ordinary income property, then the deduction is reduced by the ordinary income component.

Since the profitable sale of S corporation stock or an LLC membership interest usually produces a 100% long-term capital gain, most donors would assume that they can deduct the entire appraised value of the stock or membership interest. However, tax law provides that the income tax deduction for a charitable gift of S corporation stock or an LLC membership interest is reduced to reflect the ordinary income component of the underlying assets owned by the S corporation or the LLC. Thus, the donor who gives S corporation stock or an LLC membership interest to a charity must reduce the income tax deduction by the amount of gain that would be treated as ordinary income if the underlying assets had been sold.

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What is UBIT: History and Policy

Another consideration that will come into play when a donor wants to donate S corporation stock or an LLC membership interest is the unrelated business income tax (UBIT). Although charities are generally exempt from paying income tax on revenue from their exempt function or from their investments, they must pay tax on the charity's income from activities that are not related to their tax-exempt purpose.

The principal purpose of the UBIT is to put a tax-exempt organization on the same footing as a taxable organization when a profitable activity in which the charity has an ownership interest is not directly related to the charity's function. For example, when a tax-exempt organization raises money by selling greeting cards, it could have a competitive advantage over a for-profit corporation that sells the same cards but has to pay income taxes on its profits.

UBIT Rates: Trust Versus Corporate Tax Rates

The amount of UBIT that a charity pays depends on whether it is a trust or a corporation under state law. A charitable trust is subject to the worst UBIT rates. A charitable trust's UBIT rate on ordinary income is 37% once the unrelated income reaches just $12,500. A charitable trust's long-term capital gain UBIT rate is generally 20%.

All other charities, including state universities and the corporations they control, are subject to the UBIT rates imposed on for-profit C corporations. They are subject to a flat UBIT rate of 21% on all unrelated income, whether it is ordinary income or long-term capital gain, which can be a substantially lower UBIT rate than a charitable trust is subject to.

Application of UBIT Rules to a Charity's Ownership in LLCs and S Corporations

Although a charity might view an investment in an LLC like any other kind of investment, the income tax laws view the investment as a charity's indirect participation in an unrelated commercial enterprise: the LLC's underlying business activities.

A charity's share of an LLCs' unrelated commercial activities is subject to UBIT. But a charity does not pay any UBIT on its share of the LLC's passive investments, such as interest, dividends, rents and capital gains.

Under the tax laws, a charity's share of income from an S corporation is treated very differently from a charity's share of income from an LLC. A charity is subject to UBIT on its share of all income attributable to an S corporation, including sources that are traditionally tax-exempt to charities, such as interest, dividends, rents and capital gains. Even the gain from the charity's sale of the S corporation stock is taxable. Congress concluded that this treatment was appropriate in light of the history of granting S corporations exemption from the conventional corporation income tax.

What Should an S Corporation or LLC Owner Who Wants to Make a Charitable Gift Do?

Given the different tax rules that apply to charitable gifts of stock in an S corporation or membership interests in an LLC that operates a business, a donor should talk to the charity and to his or her advisor about the intended gift. The charity must be willing to pay the associated UBIT, or it will not accept the gift.

In addition, the advisor needs to run scenarios to see if the income and capital gains tax savings to the donor are significant enough to cover the UBIT that the charity will have to pay on its share of the S corporation or LLC income or on the sale of the interest. Most charities will deduct the UBIT from the money it will put into the Donor-Advised Fund from a sale of the interest, so there may not be a significant benefit to the gift before a sale.

New Tax Law Considerations

With the new tax law, many CPAs and attorneys are meeting with their clients to determine if they should transition their business from an S corporation or LLC to a C corporation since the corporate tax rates have been lowered. In the 1980s, a significant number of C corporations converted to S corporations, and new businesses were typically set up as LLCs based on changes to the tax laws at that time. The new law could swing the pendulum the opposite direction, decreasing the complexity of closely held stock gifts that crop up with S corporations and LLCs.

Conclusion

The Dayton Foundation has been around for almost 100 years and has provided many families with comfort knowing that their legacy of giving can live on forever. When selling their businesses, clients often find themselves in a position to provide for charity in a much bigger way than they have during their lifetime. I know from experience that The Dayton Foundation is well versed in accepting complex gifts and can be a partner in helping your clients find the right charitable fit for them and their families. ❧

*Note: For purposes of this article, any reference to an LLC should also be considered as a reference to a partnership. Solutions will differ from case to case. The above does not constitute professional financial or tax advice.

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