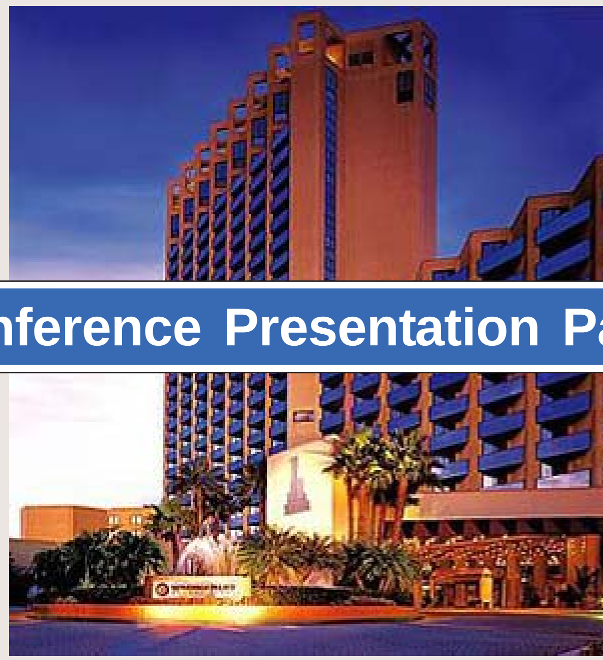
National Conference on Philanthropic Planning

October 13-15, 2010 • Orlando, Florida



Conference Presentation Paper

EXIT STRATEGIES: IF YOU CAN'T GET OUT, SHOULD YOU GET IN?

Partnership for Philanthropic Planning

October 15, 2010

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EXIT STRATEGIES: IF YOU CAN'T GET OUT, SHOULD YOU GET IN?

This presentation will discuss an often neglected aspect of charitable giving: how may a charitable organization dispose of a charitable gift. All gifts need an exit strategy. Sometimes the strategy is simple: sell the marketable security. Sometimes there is no exit strategy – consider a charity that accepts toxic land. Most gifts fall somewhere in between, with multiple potential exit strategies that should be considered before the gift is accepted.

I. GENERAL CONSIDERATIONS

A. Pre-Arranged Sale

If a donor contributes assets to a charity and the charity has the unrestricted right under state law to keep or sell the assets, as the charity alone determines, then were the charity to sell the assets any capital gain would be treated as being incurred by the charity (and ordinarily no income tax would be paid unless the assets are S Corporation stock) rather than attributable to the donor. On the other hand, if the donor contributes assets to a charity but the assets are encumbered in some way that compels the charity to sell the assets to a particular purchaser then the donor will be required to recognize any gain on the sale.

Naturally, many situations are murky, and it may be unclear whether the charity has the unrestricted right to keep or sell or actually is under some encumbrance. The basic rule, as outlined in Revenue Ruling 78-197, 1978-1 C.B. 83, and *Palmer v. Commissioner*, 62 T.C. 684 (1974), aff'd on other issues, 523 F.2d 1308 (8th Cir. 1975), is that if the donee charity is not legally obligated to sell the contributed asset then any gain on the sale will not be imputed to the donor. So, for instance, in PLR 200230004 spouses proposed to transfer 495 of 500 shares of a C Corporation to a charitable remainder unitrust and asked whether the redemption by the corporation would constitute a pre-arranged sale; the IRS held that it was not, but required the taxpayer spouses to stipulate that the trustee of the charitable remainder trust was free to sell the stock or retain it. Just because the contributed asset is subject to an agreement creating a right of first refusal or option will not change this result. For instance, in PLR 200321010 a retired executive gave corporate stock to a charitable remainder trust and the stock was subject to various restrictions and a right of first refusal, but the trustee had the final decision over a sale and there was no prearrangement.

Occasionally the IRS itself gets confused on these rules. In *Gerald A. Rauenhorst, et ux. v. Commissioner,* 119 T.C. No. 9 (2002) the government attempted to ignore Revenue Ruling 78-197, even though it was the government's own ruling. The court took a dim view of that position:

> The Commissioner's revenue ruling has been in existence for nearly 25 years, and it has not been revoked or modified. No doubt taxpayers have referred to that ruling in planning their charitable contributions, and, indeed, petitioners submit that they relied upon that ruling in planning the charitable contributions at issue.

> Under the circumstances of this case, we treat the Commissioner's position in Rev. Rul. 78-197, 1978-1 C.B. 83, as a concession. Accordingly, our decision is limited to the question whether the charitable donees were legally obligated or could be compelled to sell the stock warrants at the time of the assignments.

On egregious facts the government has won. For instance, in *Blake v. Commissioner*, 42 T.C.M. 1336, aff'd, 697 F.2d 473 (2d Cir. 1982), a gift of stock plus a charity's agreement to a redemption plus the purchase of yacht from donor equals sale of stock and gift of yacht, but those were unusual facts. Interestingly, in one instance the taxpayer has argued for a prearranged sale because it gave the taxpayer a larger charitable deduction. In *Ian G. Koblick v. Commissioner*, T. C. Memo 2006-63, 45% of a corporation was given by taxpayer to a charity, at the same time as other owners gave the remaining 55% of the corporation to the charity. The corporation owned undersea diving equipment. The corporation's Bylaws restricted sales without the corporation's consent and also gave it a right of first refusal. The corporation was not formed, apparently, for purposes of donating equipment to charity. The taxpayer argued, and the court largely accepted, that the transfer to charity was part of a prearranged plan in which the taxpayer and other donors "walked in lockstep". Thus the court applied only a 10% minority interest discount to the stock gift.

B. Arms-Length Valuation

A public charity is subject to penalties if it engages in a transaction that provides a private benefit to a donor or other member of the public. Charitable dollars are intended to be used only for charitable purposes. Some of these private benefits are well known – a charity cannot overcompensate its employees without fear of an excise tax under the intermediate sanction rules – but any transaction that results in the charity receiving the worst of a deal may be a private benefit transaction.

Whenever a charity sells assets that are not publicly traded there is a risk that the charity will sell for too little, or on other terms unfavorable to itself, and thus open itself up to the charge that it provided a private benefit to someone. A charity must always sell an asset for fair market value and on market terms. The best way to ensure that no sale of any asset occurs for less than fair market value is for the charity to insist on an independent appraisal of the asset to be sold. This may not always be popular with a donor but it is very important. The charity should not hesitate to deduct the cost of the appraisal from the charitable gift itself, but if that is impractical for purposes of donor relations the charity should pay for the appraisal as a cost of doing business.

What is an independent appraisal? In general, the charity should insist on a "qualified appraisal" as defined by Section 1.170A-17 of the Treasury Regulations to document charitable gifts for income tax purposes. If an appraiser is not familiar with the requirements then perhaps that appraiser is not appropriate to perform the appraisal the charity needs. A qualified appraisal must discuss the property interest being valued (*e.g.*, the whole farm or half the farm; or a whole corporation or 100 shares out of a 1000 total shares) and how the value was determined, among other requirements, and must be made by a qualified appraiser. A qualified appraiser is one who is trained to appraise the kind of property being appraised and has at least two years of experience doing so. There is no requirement that the charity not use the donor's appraisal or appraiser, but the charity has a separate obligation to determine that the appraiser is qualified and independent and that the appraisal was made on an arms-length basis.

II. EXIT STRATEGIES CONNECTED TO TRANSACTIONS

A. Real Estate Contributed in Exchange for a Charitable Gift Annuity

The charity is taking a big risk – it has to fund the annuity for life, as most annuities are payable immediately. In addition, in many states the charity is required to fund a reserve trust. However, the charity "only" has an interest in the property. If the contributed asset is not immediately sold then the charity must make the annuity payments from another source. As the recent economy has demonstrated, many assets that can be sold easily in ordinary circumstances may be unsalable in certain instances. Further, when the property does sell, the property may not sell for the appraised value, which is an issue if the charity issues the annuity based on the appraised value. Further, net proceeds will be reduced by selling costs.

The charity will often offer a rate lower than the ACGA rates, to help offset some of the risk, and may consider a one-year deferred CGA to help with cash flow.

A potential solution is to use a "charitable put". As noted above, having the donor identify a buyer and enter into a binding sale agreement with him/her prior to the gift results in the donor being taxed on the gain (see *Palmer v. Comm'r.*, 62 T.C. 684 (1974), aff'd on other grounds 523 F.2d 1308 (1975), Rev. Rul. 78-197). In contrast, consider having the charity identify a potential buyer prior to the gift, and enter into a "put" agreement with the buyer. Under the "put", the charity has the right to force the buyer to buy the property at a stated price – but the buyer cannot force the charity to sell. The charity will likely have to pay the buyer some amount before the buyer will agree to be obligated to buy.

At the moment of gift, the charity cannot be compelled to sell, as it has power to exercise the put or not. Plus, the donor did not negotiate the put and did not assign "his" income.

This put idea is similar to a gift of property that is subject to a right of first refusal. The IRS issued several PLRs in the early 1990's concluding that such a gift did not violate the rule set forth in *Palmer* and Rev. Rul. 78-197, as the donee charity cannot be compelled to do anything – it is only if donee charity decides to sell that any obligation becomes enforceable. See also PLR 201012050 on the gift of LLC interests subject to an option to buy.

B. Dispositions of Remainder Interests in Personal Residences and Farms

A charity that owns a remainder interest in a personal residence or farm may: (i) sell the remainder interest before the expiration of the life estate; (ii) wait and obtain full ownership of the property after the life estate expires; or (iii) sell its interest in the real estate along with the life tenant.

If the charity sells its remainder interest to a third party during the term of the life estate-remainder arrangement, the charity has an obligation to secure the appropriate value for its remainder interest, which means it must determine the value of the life estate. Should the life estate be valued using the actuarial tables issued by the IRS? In other words, is the life tenant "not terminally ill"? To avoid intrusive medical questions, a common approach is to use the normal actuarial tables with an agreement that if the life tenant dies other than in an accident or from an unexpected illness (heart attack if there is no history of heart disease) within 18 months of the sale that the sale is unwound. The donor's estate will still receive an estate tax charitable deduction under *Blackford v. Commissioner*, 77 T.C. 1246 (1981).

If the property passes to the charity at the death of the life tenant the charity may lease, sell, or retain the property as the charity determines.

The difficult case is when the life tenants can no longer live in the property (due to their advancing age, for example). If the parties agree to sell the property, the proceeds will be divided between the life tenant and the charity – generally be allocated based upon the IRS tables. The life tenants have to understand that once they enter into a life estate-remainder agreement, they own less than 100% of their home. In fact, as they age, they own (actuarially) less every year. If the donors need to move out at age 90, they own only approximately 20% of the house's value. Thus, if the parties agree to sell the property, they will receive only 20% of the proceeds. Occasionally a charity will agree to sell the property (along with the life tenants) and reinvest a portion of the proceeds into a new, less expensive residence, on the same "life estate remainder" basis. Alternatively, the parties may agree that the life tenants will lease the property and use the rental payments to secure their new residence. Note that a properly drafted "Life Estate-Remainder Agreement" between the donors and the charity will address many of these issues.

C. Dispositions of Annuity Payment Streams

A charity that is receiving a stream of payments, such as from a charitable lead annuity trust, may sell that stream of payments for fair market value determined using standard mathematical principles. The sale may be made to family members of the donor or to others as the case may be. The result of a sale is that the charity receives a lump sum that it may invest immediately; in many instances, the investment return of the charity's endowment will net the charity more money – often significantly more money – than receiving the stream of payments.

III. EXIT STRATEGIES CONNECTED TO ASSETS

A. Gifts of Land

1. Land may be sold to outsiders (third-parties), but where the donor has a "buyer" in mind a pre-arranged sale problem looms.

2. Land may be sold to insiders (family, business associates), but if so then the key issue is how should fair market value be determined?

3. Naturally, land may also be retained. There the issue is typically that it must be managed, whether through a lease or occasionally more directly. There is nothing that prohibits a charity from operating a farm directly or managing a mega-story office building or even being a slum-landlord, but unless the return on the investment is substantial the costs of management, insurance, maintenance, perhaps real estate taxes, may create a net loss.

B. Gifts of Condominiums

A condominium is a special sort of land that is more complicated because it comes with the restrictions and requirements of the condominium agreement itself. The charity may lease and manage it or sell it, but until it is sold the charity must pay the carrying charges that typically include an association fee.

C. Gifts of Business Interests

Business interests make attractive gifts. There are two typical transactions. One, a donor regularly gives small interests in a business to a charity and the business just as regularly makes an offer to redeem the interest for appraised value. Two, shortly before a contemplated sale of the business a donor gives some portion of the business to charity so that when the business is sold the charity is benefitted without the donor incurring capital gains tax on that portion of the sale. In the first case the primary issue is valuation, and in the second the primary issue is whether there is a prearranged sale.

1. Closely-Held C Corporation stock is the easiest business asset to deal with because for income tax purposes the corporation pays its own tax. Thus a charity may receive the stock and if there is no sale to insiders (typically a redemption) or outsiders (usually a sale of the whole business) the charity may continue to hold the stock without much difficulty. An exception would be if the charity has planned to use the sales proceeds to fund a private annuity (as discussed above) or if the charity has planned to use the sales proceeds immediately to build something or fund a charitable program.

2. S Corporation stock is entirely different from C Corporation stock. It is very important to determine what the tax treatment of the corporation is. An S Corporation does not pay income taxes but rather passes its tax liability on to the charity. Thus, the charity should know when it accepts a gift of S Corporation stock how it is going to pay any resulting income tax; the usual solution is that the donor agrees to reimburse the charity. For this reason, the longer the charity must hold the stock the more income tax is likely to be paid. When the charity sells the stock that too is taxable, contrary to all the normal rules that charities do not pay income taxes. Thus the charity must have an agreement with the donor that the taxes will be taken out of the sales proceeds. When a charity receives a gift of S Corporation stock it should consider what the real value of the stock is to it because the answer is almost certainly less than the fair market value.

3. A Limited Liability Corporation (LLC) has units rather than stock. It too passes through its tax liability, but there will likely not be any income tax due when the LLC units are sold. An agreement with the donor is prudent when the gift is received.

4. Partnership Interests are similar to LLC units. A partnership passes through its income tax liability. A charity should never accept a general partnership interest without careful study and the involvement of experienced outside counsel because general partners are liable for all the acts of a partnership – thus ownership is risky. Ownership of a limited partnership interest is less tricky, but an agreement is required to ensure that the charity does not pay unexpected income taxes.

A special note about private benefits is warranted here. Almost any redemption of a business interest will be done at a discount from pro rata value. Consider a business worth $1,000,000 that has 1000 shares of stock. If a charity is given 100 shares of stock the charity has a 10% "say" in the operation of business, which is no say at all. For this reason an appraiser will discount the value of the 10% interest – its pro rata value is 100/1000 x $1,000,000, which is $100,000. An appraiser will likely conclude that 100 shares are worth in total perhaps $65,000. That would be referred to as a 35% discount. Suppose the corporation then redeems the 100 shares for $65,000, and to make it easy let us assume that the corporation goes to Worthy National Bank and borrows the $65,000. Now the corporation is worth $1,000,000 – $65,000 (the amount borrowed), or $935,000. How many shares of stock are there outstanding? 1000 – 100 = 900. What has happened to the value of 100 shares? Now the 100 shares has a value of 100/900 x $935,000, which is $103,889. In effect, by making the charitable gift of 100 shares that are redeemed by the corporation the donor has increased the value of all the other shares. Is this a private benefit? As long as the charity receives fair market value the answer is no.

But beware – many strategies exist that attempt to trap a charity into receiving a fraction of what is fair market value, and charities must be careful to avoid being used as intermediaries to enhance family benefits.

D. Gifts of Life Insurance

Many charities will accept gifts of life insurance policies. The gift is deductible if the charity is made the owner and the irrevocable beneficiary of the policy. If the policy is not fully paid-up, many charities will request/require that the donor make annual gifts sufficient to cover the annual premiums.

Charities should ensure that they have the right to exercise any option regarding the policy: retaining the policy, continuing to make premium payments, surrendering the policy to the insurance company, or selling the policy to a third-party. Practically, if the policy is fully paid-up or the donor is continuing to make gifts sufficient to cover the annual premiums due, most charities will continue to hold the policy. What, however, if the donor stops funding the additional premiums? One option is to surrender the policy back to the insurance company for its "cash surrender value". A second option exists for *some* policies – selling it on the market.

Third-party buyers will bid in excess of cash surrender value for certain policies – but the buyers tend to want valuable policies on elderly (and not very healthy) insureds.

If you sell a policy on the market, note Rev. Rul. 2009-13. In this Ruling, the IRS provided guidance addressing the character of gain realized on the sale of a life insurance policy. The Ruling notes that the gain on the sale of the policy is the excess of the amount realized over the seller's adjusted basis. The IRS concluded that an insurance policy may have both investment characteristics and insurance characteristics, and that a portion of the premiums paid represented the cost of the annual insurance protection during the term of the policy. The IRS thus held that the seller's basis was the cost of the premiums paid less the amount expended as the cost of insurance.

As to the character of the gain, the IRS applied the "substitute for ordinary income" doctrine to characterize part of the gain on the sale as ordinary income, despite the fact that the policy was in general a capital asset. The amount that is to be recognized as ordinary income is the amount that would be deemed ordinary income if the policy were surrendered (*i.e.*, the inside build-up in the policy). The balance of the gains is to be characterized as long-term capital gain.

Note that this Ruling has implications regarding a donor's deduction for a gift of a policy. The FMV of an item of property for income tax charitable contribution deduction purposes is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell. Regulation Section 1.170A-1(c)(2). The IRS has issued guidance on the valuation of insurance policies in other contexts, including gifts to individuals (see Regulation Section 25.2512-6(a)). This guidance states that a policy's value is its interpolated terminal reserve plus any unused premium. Many articles and treatises discussing charitable gifts of life insurance policies state that the value of the policy for Code Section 170 purposes should be determined pursuant to these gift tax regulations. However, these regulations are specifically limited to gift tax consequences only, and further contain an exception for policies where the formula amount "is not reasonably close to the full value". Given that there is a secondary market that values certain policies in excess of their cash surrender value or interpolated terminal reserve, a donor of such a policy should be able to support an increased deduction (*i.e.*, the FMV of the policy) if they can secure a qualified appraisal prepared by a qualified appraiser.

IV. IF THERE IS NO EXIT STRATEGY

A. Do Not Accept the Asset

You do not have to accept a gift – not only can you decline a gift as it is being offered, but a beneficiary may disclaim any interest, in whole or in part, by filing a disclaimer. There is both federal tax law on disclaimers (IRC Section 2518) and state law, which varies widely.

1. California's disclaimer rules are in Probate Code Section 275. They provide that the disclaimer must be in writing, identify the creator of the interest, describe the interest being disclaimed, and state the disclaimer.

2. With whom the disclaimer must be filed depends upon the situation: the Probate Court (for bequests under a will), the trustee of a trust, the person responsible for distributing the interest, the person having possession of the asset, or the creator of the interest.

3. Note a beneficiary cannot disclaim an interest after he/she/it has accepted the interest.

4. A disclaimer is effective if it is filed within a "reasonable time" after the beneficiary acquires knowledge of the interest. In the case of certain types of interests, there are special rules that provide when a disclaimer is conclusively presumed to have been filed within a "reasonable time".

5. How does this work with a CRT? Consider a CRT that provides: "at the termination of the trust, the trustee is to distribute the remainder to Charity 1; and if it is not then a qualified charity, the trustee is to distribute the remainder to Charity 2."

   a. If Charity 1 does not want to accept the trust assets, it should disclaim within nine months after the later of: (1) the time it first acquires knowledge of the interest, (2) the time its interest becomes indefeasibly vested, or (3) when the interest becomes an estate in possession (as the remainder interest is a "future estate").

   b. If Charity 1 disclaims, Charity 2 should disclaim within nine months the later of: (1) the time of the first disclaimer, (2) the time it first acquires knowledge of the interest, (3) the time the interest becomes indefeasibly vested, or (4) when the interest becomes an estate in possession (as the remainder interest is a "future estate").

B. Consider a Short-Term CRT to "Cleanse" the Asset

Consider having the donor contribute the asset to a 5% net income CRT with the donor serving as trustee and a 3-year term. The liability remains with the donor (now serving as trustee). The donor hopefully sells the property promptly, and invests the proceeds until the trust termination date.

Donor's deduction is approximately 85% of the building value.

How short a term can you use? IRC Section 664(d)(2)(A) refers to payments continuing for "a term of years" (not in excess of 20 years).

How do you minimize income back to donor after the property is sold? Use a net income payment form, have the donor invest for growth and not income, and include the charity as an income beneficiary.

An alternative: use a more traditional long-term CRT, and have the donor give his income interest to charity after the asset is sold, and then collapse the trust. See Rev. Rul. 86-60.

V. GIFT ACCEPTANCE POLICIES

A. The Role of a Gift Acceptance Policy

A charity's GAP should, among other things, address what kinds of assets and gift vehicles the charity will consider accepting.

Who in the organization decides whether real estate is acceptable?

What information is required to make a decision?

How will costs of maintenance, upkeep, insurance, taxes, and debt service be handled?

B. Key Issue – "Who Decides"

The following is a sample "acceptance procedure":

1. Approval by the Development Director. Except as provided below, gifts that comply with this policy may be accepted by the Development Director. If the Development Director determines that a proposed gift does not comply with this policy or is otherwise not in the best interests of the charity, he/she shall refer the matter to the Planned Giving Committee for a final decision on whether to accept the gift.

2. Approval by Planned Giving Committee. Gifts meeting the following criteria may be accepted only after review and approval by the Planned Giving Committee:

    - Planned giving agreements that require continuing financial management,

    - Any gift of tangible personal property with an estimated value of $2,000 or more,

    - Any gift restricted as to spending or purpose that requires the creation of a new fund (but not gifts made to an existing endowment or purpose-restricted fund), or

    - Any gift of $100,000 or more.

The Planned Giving Committee reserves the right to reject any gift for any reason at its discretion.

3. Approval by the Board of Directors. Gifts of real estate, intangible assets that are not publicly traded, or any non-standard contribution must be specifically approved by the Board of Directors.

4. Negotiation and Approval of Agreements. The Development Director shall negotiate all planned giving agreements. The persons authorized to sign planned giving agreements on behalf of the charity are the President and Treasurer.

5. Legal Counsel. The charity may seek the advice of legal counsel where appropriate, and shall seek the advice of legal counsel in all matters pertaining to the acceptance of a gift that may have adverse legal, ethical, or policy consequences to the charity. Review by legal counsel is also usually sought in connection with:

- Closely held stock transfers that are subject to restrictions or buy-sell agreements;
- Documents naming the charity as trustee;
- Gifts involving contracts, such as bargain sales or other documents requiring the charity to assume a legal obligation;
- Gifts of patents and intellectual property;
- Transactions with potential conflict of interest that may invoke IRS sanctions; or
- Other instances in which use of counsel is deemed appropriate by the Planned Giving Committee.