Charitable Transfer for Partnership Holdings

Summary
For an individual holding an interest in a business or investment entity taxed as a partnership, a charitable transfer can create an attractive planning opportunity while providing welcome support to a favored charity. In this article, North Carolina-based CPA and philanthropic consultant Dennis Walsh provides a concise overview of the issues surrounding charitable transfers of these entitites.
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For an individual holding an interest in a business or investment entity taxed as a partnership, a charitable transfer can create an attractive planning opportunity while providing welcome support to a favored charity. A transfer may be crafted as an outright gift, a sale followed by donation of the proceeds, or part gift/sale as needed to satisfy the charitable, estate, and succession objectives of the donor.

In the case of an interest in an active business, the tax benefit of a charitable donation can usually be optimized at a time when the entity is performing at or near its historical high. A fair market value deduction that captures enterprise value and untaxed appreciation of tangible assets can result in greater tax savings than the contribution of the proceeds of a sale of the business interest or from the liquidation of its underlying assets.

Such an enhanced charitable deduction may be appealing to partners in passive investment entities as well. And it is not unusual for investors in such entities to be burdened with annual reporting delays combined with tax compliance costs disproportionate to the investment return. Even where an interest has not appreciated in value, a lifetime transfer can help simplify the owner's estate and relieve survivors of administration of an asset that tends to be illiquid and difficult to value.
But the transfer of a partnership interest poses special challenges for both a transferring partner and recipient charity. Great care must be exercised to avoid inadvertent consequences and attain the desired charitable benefits.

This article introduces criteria for evaluating the benefits and costs of a charitably motivated transfer of a partnership interest. It compares possible results of three alternatives: an outright gift of the interest to the charity, a bargain sale to the charity, and sale of the interest to a third party followed by gift of the proceeds to the charity. It also illustrates how a bargain sale may be used to minimize estate loss and still accomplish charitable objectives.

Throughout the article, the term partnership includes a limited liability entity classified as a partnership for federal income tax purposes. All Section references are to the Internal Revenue Code and Regulations.

General Rules

Gain from the sale or exchange of a partnership interest is considered gain from the sale of a capital asset (§741). The contribution of property to a qualifying charity is deductible at fair market value, except for gain that would not be treated as long-term capital gain if the property had been sold at its fair market value on the date it was contributed (§170(e)(1) and Treas. Reg. §1.170A-1(c)(1)). However, the deduction for long-term capital gain property contributed to a private foundation, other than an operating foundation, is generally limited to the lesser of fair market value and cost or other basis of the property.

Adjusted Basis and At-Risk Amount

In order to evaluate the tax impact of a sale versus an outright gift, the adjusted basis of the partnership interest must be known. Before application of the passive loss limits (discussed next), recognition of any item of partnership loss or deduction is initially limited to the partner's adjusted basis and then to the amount at risk. These amounts may be different if the partner's personal liability is limited by the nature of the entity, nonrecourse debt (other than qualified nonrecourse debt), or by a loss-limiting agreement.

A partner's share of partnership liabilities is added to the partner's basis to determine the total adjusted basis of the interest. The at-risk amount is similarly increased to the extent the partner is personally liable for partnership debt. If the at-risk rules of §465 are in play, then the partner should have filed a separate IRS Form 6198, At-Risk Limitations, indicating the amount at-risk as of the end of the year.
Passive Activity Losses

In the case of a partner who has not at all times materially participated in any trade or business activities of the partnership, it should be determined whether the partner has accumulated unrecognized losses with respect to such activities as a result of the passive loss limitations of §469. If passive losses are present, the tax benefit will be forfeited to the extent allocable to a gift (§469(j)). Instead, suspended losses allocable to a gift are added to the carryover basis to the donee.

Effect of Hot Assets

Another important consideration in evaluating a gift or sale is an exception to the §741 rule that gain recognized from the sale or exchange of a partnership interest is gain from the sale of a capital asset. The presence of §751 "hot assets" in the partnership will affect the character of gain recognized from a sale as well as the allowable amount of a charitable contribution of the interest.
Hot assets include unrealized receivables, inventory items that have appreciated to a fair market value exceeding 120% of their inside basis, and §1245/§1250 property to the extent of depreciation recapture. Gain realized from a transfer of such property treated as a sale is ordinary income. And the amount of a charitable contribution deduction must be reduced by the amount of any ordinary income that would have been realized if the property had been sold at fair market value on the date contributed.

Relief of Partnership Debt

If a partner is relieved of any debt as a result of the transfer of a partnership interest, it is treated as an amount realized (§752(d)). While the relief of debt does not provide any immediate consideration to a transferring partner, the elimination of a liability improves the partner's economic position. In addition, if the debt was included in the partner's at-risk amount, the partner has either received an equivalent tax benefit from past partnership deductions or will receive an offsetting deduction of such remaining basis allocable to a sale.

Bargain Sale

Assuming that there is no receipt of cash or other consideration and that the partner is not relieved of any amount of partnership debt, there would be no amount realized as the result of transfer of a partnership interest to a charitable organization. But when a partner receives consideration and the total amount realized is less than the fair market value of the interest, the transfer is classified as a bargain sale.
In such case, the transaction is separated into a gift and a sale. The total amount realized is subtracted from the fair market value of the interest and the difference is considered a gift.
However, a sale between a private foundation and a "disqualified person," as defined in §4946(a), is a prohibited act of self-dealing. Further, Treas. Reg. §53.4941(d)-2(a)(1) provides that a sale of stock or

other securities by a disqualified person to a private foundation in a bargain sale is treated as an act of self-dealing regardless of the amount paid.

The bargain sale provisions of §1011(b) limit the amount of a partner's basis that may be allocated to the portion of an interest sold. The partner's basis in the partnership interest, along with any suspended passive losses, must be prorated between the portions deemed gifted and sold. The basis that the partner is able to use in calculating gain must bear the same ratio to the total basis that the amount realized from sale bears to the total fair market value of the partnership interest. No loss may be recognized if the amount realized is less than the basis allocated to the sale portion (Treas. Reg. §1.1001-1(e)(1)).

Ordinary income and capital gain realized on a bargain sale must be separately allocated to the sale and gift portions as well. The ordinary income and long-term capital gain that would have been realized on a fair market value sale of the entire interest are allocated to the sale and gift portions based on the ratio that the fair market value of the sale and gift portions each bear to the fair market value of the entire interest (Treas. Reg. §1.170A-4(c) (3)).
Examples of the allocation of basis, calculation of recognized gain, and reduction of a charitable contribution as the result of a bargain sale or an ordinary income element are provided in Treas. Reg. §1.1011-2(c).

Valuation

If a transfer is structured as an outright gift or as a bargain sale, a principal planning concern will be determining the value of the partnership interest so that the charitable contribution deduction is fair and sustainable, and that in the case of a bargain sale that adjusted basis, suspended passive losses, and §751 hot assets are properly allocated between sale and gift portions.
Because of the derivative nature of a partnership interest and the typical absence of readily available market quotations, determining fair market value may pose a challenge in some cases. If the interest was acquired through a broker, the partner might ask the broker for help locating an active over the counter market for the interest or contact the entity directly.
Absent an active market, however, the partner's ability to determine a supportable value may be a more formidable task. Though more than 50 years old, IRS Revenue Ruling 59-60 remains the defining methodology for determining the value of a closely held business interest.
When the claimed value of this type of donation is more than $5,000, the donor must obtain a written appraisal from an appraiser meeting the qualifications set forth in the instructions to IRS Form 8283, Noncash Charitable Contributions. Fees from appraisers or other experts for valuation of a closely held business interest are usually substantial and may render a donation of this type cost prohibitive in some cases.

Planning Approach

Planners should initially consider any restrictions on the transferability of an interest as provided by the partnership agreement or a buy-sell arrangement. Evaluate the gift versus sale potential of the interest or each interest separately if multiple interests are under consideration. For each, obtain the following:

- Adjusted basis
- At-risk amount
- Suspended passive losses
- Amount of §751 hot assets attributable to the interest
- Share of partnership liabilities
- Estimate of fair market value with consideration of a minority interest discount when appropriate
- Estimate of appraisal and transfer costs

Once this data is in hand, multiple prospects can be analyzed individually and in combination. Pro forma tax calculations can help planners minimize net gift cost while meeting the partner's charitable objectives. This should include consideration of any changes to income and deductions calculated by reference to adjusted gross income as well as other unique client factors. State and local income taxes need to be considered also.

Planning Illustration

The following case illustrates the federal tax issues discussed thus far.
Example: For the past 10 years Bob, age 60, has been a member of XYZ, a limited liability company (LLC) treated as a partnership for federal income tax purposes. He does not materially participate in the business activities of XYZ. Bob has adjusted gross income of $175,000, a federal marginal tax rate of 25%, and files jointly with his spouse. Bob's current contribution ceiling for capital gain property contributed to a qualifying organization other than a private foundation is therefore $52,500 ($175,000 x 30%) (§170(b)(1)(C)(i)).

Bob estimates the fair market value of his interest in XYZ to be $50,000. He reasonably expects XYZ to continue annual income distributions of approximately 7%, or $3,500.

Bob's adjusted basis and amount at risk in XYZ is $26,000. He has $4,000 of suspended passive activity losses with respect to XYZ. He is personally liable for $5,000 of XYZ debt. His interest includes $3,000 of §751 hot assets.

Bob wants to provide for ABC, a §501(c)(3) public charity, by donating his interest but is unsure of the tax implications of such a transfer. He is undecided whether to donate the entire interest, sell it to a third party and then contribute the cash proceeds, offer it for sale to ABC at a bargain price, or take no current action. He has asked you to help him determine his best course of action.

Scenario A –Outright gift of the entire interest to ABC

Scenario B – Sale to a third party for a cash price of $50,000 and contribution of the proceeds to ABC

Scenario C – Bargain sale to ABC for a cash price of $10,000

Step 1 – Determine the separate sale and gift elements. The resulting percentages will be used to allocate basis, long-term capital gain, and ordinary income where the bargain sale rules apply.

Step 2 – Calculate the separate tax effect of the sale and gift elements.

Step 3 – Summarize the results to determine the net cost of the gift:

	A		B		C	
Sale and gift elements:						
Value of interest	$50,000		$50,000		$50,000	
Amount realized:						
Cash received	-		50,000		10,000	
Relief of debt	5,000		5,000		5,000	
Amount realize & sale %	5,000	10%	$55,000	100%	15,000	30%
Gift element & gift %	$45,000	90%			$35,000	70%
Tax effect of sale element:						
Amount realized	$ 5,000		$55,000		$15,000	
Basis of partnership interest (1)	2,600		26,000		7,800	
Gain realized	$ 2,400		$29,000		$ 7,200	
Gain recognized:						
Ordinary income (hot assets) (2)	300		3,000		900	
Long-term capital gain (3)	2,100		26,000		6,300	
Total gain recognized	$ 2,400		$29,000		$ 7,200	
Tax:						
Ordinary income (25%)	75		750		225	
Capital gain (15%)	315		3,900		945	
Total tax on sale	$ 390		$ 4,650		$ 1,170	
Passive loss recognized (4)	$ 400		$ 4,000		$ 1,200	
Tax savings (25%)	100		1,000		300	
Tax effect of gift element:						
Gift	45,000		50,000		35,000	
Less allocated ordinary income (5)	2,700		-		2,100	
Charitable contribution deduction	$42,300		$50,000		$32,900	
Tax savings (25%)	$10,575		$12,500		$ 8,225	
Net cost of gift:						
Value of interest	50,000		50,000		50,000	
Less cash received	-		(50,000)		(10,000)	
Plus cash contributed	-		50,000		-	
Plus tax paid on sale element	390		4,650		1,170	
Less tax saved on passive loss	(100)		(1,000)		(300)	
Less tax saved on gift element	(10,575)		(12,500)		(8,225)	
Net cost of gift	$39,715		$41,150		$32,645	

(1) $26,000 x sale percentage
(2) $3,000 x sale percentage
(3) Total gain realized less ordinary income recognized
(4) $4,000 x sale percentage
(5) $3,000 x gift percentage

Comparing Outcomes

Although scenario A involves an outright gift with no cash received, the $5,000 relief of debt is treated as an amount realized on sale and triggers application of the bargain sale rules.

In scenario B, it is assumed that the buyer would be willing to pay fair market value for Bob's share of net assets and in addition assume contingent liability for his share of XYZ debt. In practice the total consideration given at the time of purchase will of course depend upon the buyer's assessment of the financial strength and future earning capacity of the entity.

In scenarios A and C, if ABC prefers to liquidate the interest immediately instead of carrying it for future cash flow, with careful planning it may be possible for XYZ to liquidate the interest subsequent to the donation while preserving Bob's deduction on the appreciated value of his share of long-term capital gain assets contributed.

Alternatively, if XYZ initially liquidates Bob's interest and he then contributes the cash proceeds to ABC, he will lose the benefit of a charitable deduction on such untaxed appreciation. However, in order to avoid having the initial transfer to ABC disregarded under the assignment of income doctrine and treated instead as a taxable liquidation of Bob's interest, there must be no legally binding obligation among the parties to carry out a subsequent liquidation (IRS Revenue Ruling 78-197).
As illustrated by a comparison of scenarios A and B, if Bob does not consider the added tax savings from an outright gift to be substantial, he might prefer instead to give ABC the cash realized from a fair market value sale of the entire interest to a third party and thereby save ABC costs incident to disposition or ongoing administration of the asset.

In addition, the greater the proportion of hot assets represented in a partnership interest, the less will be the added tax benefit of an outright gift as opposed to sale to a third party and contribution of the proceeds. Unlike long-term capital gain, no charitable deduction is allowable on an ordinary income element.

This alternative may also be more attractive where the sum of the adjusted basis (or at-risk amount if less) plus any suspended passive losses is in excess of the fair market value of the interest (i.e. the interest is depreciated). Significantly, recognition of suspended passive losses is triggered where the entire interest is disposed of in a fully taxable transaction; that is, one in which any gain or loss realized is fully recognized.

In such case, suspended passive losses are freed up for deduction in addition to any remaining basis in the interest. Depending on the amount of suspended passive losses, unrecovered basis, and marginal tax rate of the donor, the resultant added tax saving will help reduce the net cost of the gift.
As illustrated by scenario C, a bargain sale can provide a good deal of planning flexibility and may be attractive to the charity where the purchase price is nominal in relation to expected cash flow. ABC would expect to realize an annual return of 35%, represented by income distributions from XYZ of $3,500 divided by its investment of $10,000. In addition, cash received by a donor in a bargain sale may be combined with current tax savings to provide for wealth replacement as discussed next.
A fourth scenario would be for Bob to retain ownership of the interest, contribute cash distributions to ABC as received from XYZ, and revisit this analysis from time to time as circumstances change.

Wealth Replacement

Where donor objectives warrant, consideration may be given to the use of life insurance to replace wealth lost to the estate as a result of a charitable transfer.
Building on our example, at age 60 Bob's life expectancy is 25 years (per Table I in Appendix C of IRS Publication 590. It is assumed that Bob will be able to realize a similar investment yield of 7% over the long term. And for simplicity it is assume that the underlying assets of XYZ are not of a nature that will further appreciate in value.

Accordingly, the future value of the forfeited year-end XYZ income distributions of $3,500 over Bob's life expectancy is approximately $237,000. Adding this amount to the $50,000 value of the interest to be replaced, Bob's total insurance requirement is $287,000.

Bob is in good health and has been quoted a guaranteed annual premium of $1,335, payable at the beginning of each policy year, for a suitable universal life policy with a death benefit of $287,000. In scenario C, cash flow from his immediate net tax savings of $7,355 combined with the bargain sale proceeds of $10,000, totaling $17,355, exceeds the present value of the insurance premiums paid over his life expectancy, $16,600.

Thus, if Bob elects the bargain sale alternative, he will provide ABC with a high-yielding asset and stands a reasonable likelihood of fully restoring wealth otherwise lost to his estate as a result of the charitable transfer.

Conclusion

A well thought out gift or sale of a partnership interest may create an income tax and estate planning opportunity for a transferring partner as well as vital support for a preferred charitable organization. But a partnership interest carries special issues that need to be explored in advance in order to capture maximum tax benefit and avoid unintended outcomes. Any costs incident to transfer and ongoing administration should be considered as part of this analysis.

Planners can also aid the charity in the exercise of its stewardship by alerting principals to concerns that should be addressed before accepting this type of gift, such as unrelated business income tax and transfer of liabilities. For a discussion of these concerns, see "Receiving a Gift of a Partnership Interest: What Charities Should Know," by Dennis Walsh, CPA, appearing in the February 2011 issue of the *Journal of Accountancy*.

About the Author

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