Planning and Drafting Gifts and Trusts of Closely Held Stock

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American Institute for Cancer Research

Major Gifts, Trusts and Bequests
For the American Institute for Cancer Research

The American Institute for Cancer Research is devoted to the task of conquering our nation's most dreaded illness. Each year, the Institute sponsors important research projects at universities and research facilities across America, focusing on the cause and prevention of cancer. It has long been a leader in providing effective educational programs on the prevention of cancer – directed to both health care professionals and the general public.

The primary focus of the American Institute for Cancer Research – in both its research projects and its educational programs – has been the role of diet and nutrition in the development and prevention of cancer. (There is scientific evidence that estimates an average of 35% of all cancer deaths might be linked to diet and nutrition.)

We are winning the war against cancer. But there is still a great need for additional scientific research on the cause, prevention and treatment of cancer. As we learn more about the role of nutrition in the cause and prevention of cancer, our educational programs become more and more important and rewarding.

Millions of Americans provide financial support to our programs – often through tax-planned gifts, trusts and bequests. To encourage, facilitate and recognize this very important financial support, the Institute has created the League of Willful Cancer Fighters. We will be pleased to enroll in the League any client who has made or intends to make a bequest to the Institute or name the Institute as the beneficiary of a trust, life insurance policy, retirement death benefit or other form of estate gift. We invite you or your client to call us at your convenience.

We have prepared this booklet to help attorneys and other financial advisers understand all the important tax and financial rewards Congress has provided. Our staff can provide the exact tax and financial consequences of any gift, trust or bequest your clients may want to consider. Because we are so active in this specialized field, we can provide whatever technical and practical information you may request for planning and drafting a charitable gift arrangement that will provide your clients both the greatest personal satisfaction and the greatest tax and financial rewards.

Please feel free to call the Gift Planning Office at any time. Our toll-free telephone number is 1-800-843-8114. And please . . . if the opportunity presents itself, inform your clients about how a gift, trust or bequest to the American Institute for Cancer Research can help in the fight against cancer, while also enhancing their personal tax, investment, retirement and estate plans.

PLANNING AND DRAFTING CHARITABLE GIFTS AND TRUSTS OF CLOSELY HELD STOCK

Closely held corporations come in many different shapes and sizes. There are closely held corporations (roughly defined as corporations whose stock is not publicly traded) with assets or revenues in the hundreds of millions of dollars and literally hundreds of stockholders. There are other closely held corporations where there are only one or two stockholders and the assets and revenues of the corporation are less than one hundred thousand dollars.

More than one million Americans own stock in a closely held corporation. Typically, the stock pays little or no dividends, has a value far in excess of what the owner might believe the value to be, represents full or partial active control over or involvement in the corporation, cannot easily be sold to unrelated parties and has appreciated significantly in value.

Owners of closely held stock all too often see the stock as a rigid asset that lacks the flexibility of publicly traded stock or other assets. They might never consider funding a major gift to the American Institute for Cancer Research with closely held stock, or transferring closely held stock to a charitable remainder trust that would provide important tax and financial benefits for them (and assure a later gift to the war against cancer).

In many cases, a charitable remainder trust will provide a great opportunity for the closely held business owner to:

(a) sell his or her appreciated closely held stock without paying capital gains tax;

(b) be assured of a lifetime income and immediate tax benefits without losing control of the corporation;

(c) pass control of the business to children or employees with very favorable gift or estate tax consequences;

(d) avoid or minimize a potential accumulated earnings tax;

(e) minimize or avoid potential gift and estate taxes;

(f) provide a tax-favored income to family members;

(g) build a high retirement income within an effective tax shelter; and

(h) make a meaningful gift to the war against cancer at a very modest after-tax cost.

OUTRIGHT CHARITABLE GIFT OF CLOSELY HELD STOCK

A client can make an outright gift of closely held stock to the American Institute for Cancer Research in much the same way he or she would make a gift of publicly traded stock. The client simply mails (or otherwise delivers) an endorsed stock certificate, or a stock certificate and an executed stock power, to the Institute.

Just as with a gift of publicly traded stock, the client can claim an income tax charitable deduction for the fair market value of the closely held stock as of the time the gift was completed (assuming the stock was held for more than one year). And the client will not incur capital gains tax no matter how much the closely held stock may have appreciated in value.

Although making a gift of closely held stock to the Institute generally presents no technical problems, there can be practical hurdles. Your client may be very reluctant to give the Institute (or any other charitable organization) any active interest in or control over the corporation. Also, the Institute would be reluctant to accept a gift of closely held stock that provides little or no dividend income and may be difficult or impossible to sell at a fair price.

The strategy that can often make a gift of closely held stock attractive to your client and the American Institute for Cancer Research is to have the client's corporation redeem or purchase the stock from the Institute at its fair market value.

The client transfers the stock to the Institute and claims an income tax charitable deduction for the value of the stock. A short time later, the corporation redeems the stock from the Institute for its fair market value and retires the stock.

Valuation of Closely Held Stock

Determining the fair market value of closely held stock given to the American Institute for Cancer Research can be a very inexact science. But it is obviously necessary to obtain an accurate appraisal of the value of the stock in order to determine the amount of the client's charitable deduction.

The corporation's earnings and dividend paying capacity are generally the most important factors in determining the value of closely held stock. Other factors that must be considered include the nature of the business, the economic outlook for the particular industry, price-earnings ratios of publicly traded corporations in the same industry, the book value of the corporation and the size of the block of stock given to the Institute.

One easy and generally acceptable way to roughly estimate the value of a closely held corporation is to: (a) determine the amount of income that should reasonably be produced by the tangible assets of the corporation (generally 7% to 9% of the current value of the tangible assets); (b) determine the extent the average income of the corporation exceeds the reasonable income from the tangible assets; (c) compute the value of the intangible asset (goodwill) that would reasonably produce the excess income (typically, the excess income is capitalized by a factor of from 7 to 9); and (d) add the value determined for goodwill to the value of the tangible assets.

Example: Paul owns most of the stock of a small printing company that has had an average income of $80,000 over the past five years. The value of its tangible assets is $600,000. Using an 8% factor, the reasonable income from the tangible assets would be $48,000. The excess income of $32,000 could be capitalized at a factor of 7 to determine that the value of goodwill is $224,000. Result: the estimated value of the corporation is $824,000.

The corporation has 1,000 shares of stock outstanding. Paul gives 50 shares to the American Institute for Cancer Research to support its research and educational programs aimed at the prevention of cancer through good nutrition and a sound lifestyle. The value of the gift can be roughly estimated at $41,200 (5% of $824,000), less an 8% or 10% discount to reflect the lesser value of a minority interest.

Note: A rough estimate is not sufficient to substantiate a charitable deduction. A qualified appraisal would be required in the above example.

A Qualified Appraisal Is Generally Required

If the value of the closely held stock given to the Institute exceeds $10,000, a qualified appraisal will be required to substantiate a charitable deduction. IRS Form 8283, signed by the appraiser, the donor and the Institute, must be filed with the donor's income tax return claiming a charitable deduction for the gift.

The Institute is required to file a Form 8282, reporting the price received from any sale or redemption of the closely held stock within two years after the date of the gift.

There are several specific requirements for a qualified appraisal of closely held stock. The appraiser, in addition to being qualified to fix the value of closely held stock, must be independent of both the donor and the charity and must hold himself or herself out to the public as an appraiser. The appraisal must be in writing and contain a full description of the stock, including any restrictions on the right of the donor to sell or transfer the stock. The qualifications of the appraiser, the method of valuation and the fee arrangement must be stated in the written appraisal.

The appraisal must have been made no more than 60 days before the date of the gift and not later than the due date (with extensions) of the return claiming a charitable deduction for the gift.

Redemption of Stock From the Institute

In the vast majority of cases, your client will want his or her corporation to redeem the closely held stock the client has given to the Institute.

There was a time when the IRS took the position that the donor of closely held stock realized a capital gain or dividend income when the corporation he or she controlled redeemed the stock given to charity. However, in 1978 the IRS said it would not treat a redemption of stock given to charity as gain or income to the donor unless the charity was legally bound, or could be compelled by the corporation, to surrender the shares to the corporation.

Your client can give part of his or her closely held stock to the war against cancer with the clear understanding that the Institute will hold the stock and, when requested, sell it to the corporation at its fair market value. So long as the Institute is not legally obligated to sell the stock, there is no risk of adverse tax consequences to the client.

Financial Consequences of a Gift and Redemption of Closely Held Stock

Robert J. owns all the stock of Iona corporation. He wants to make a gift of $10,000 to the Institute that will be restricted to scientific research into the treatment and prevention of prostate cancer. He is in a 40% combined state and federal income tax bracket.

Robert gives shares of Iona stock with an appraised value of $10,000 to the Institute. Six months later, Iona redeems the stock from the Institute with a cash payment of $10,000.

After the redemption, Robert still owns all the outstanding stock of the corporation and he has reduced his personal income tax liability by $4,000. He has used corporate funds that have never been taxed to him to make a charitable gift that has produced meaningful tax benefits for him.

A gift of closely held stock to the American Institute for Cancer Research followed by a redemption of the stock from the Institute can be financially attractive to the donor because: (1) the donor gains an immediate income tax charitable deduction; (2) the donor avoids paying capital gains tax on the appreciation in the value of the stock given to the Institute; (3) the donor gets cash out of the corporation tax free; and (4) a corporate accumulated earnings tax may be minimized or avoided.

The fact remains, however, that in most cases, the corporation does not gain any income tax or other financial benefit by paying the redemption price of the stock to the Institute.

Creating an ESOP To Redeem the Stock

In appropriate cases, the client's corporation may want to create an employee stock ownership plan (ESOP). It can deduct the cash it contributes to the plan – generally up to as much as 25% of compensation paid to participating employees. And the ESOP can use the tax deductible contribution to redeem stock from the Institute. Indeed, the ESOP can generally borrow funds – often at low interest rates – to redeem the stock from the American Institute for Cancer Research. The loan will be repaid with the future tax deductible contributions of the corporation.

With an ESOP in place, a client in a 40% state and federal tax bracket can give stock worth $10,000 to the war against cancer at an effective after-tax cost of only $2,000, assuming the corporation is also in a 40% combined state and federal income tax bracket. The after-tax cost of giving $10,000 to the ESOP would be $6,000, and the client would gain a $4,000 personal tax saving.

Charitable Remainder Trust Option. The majority owner of a corporation can sell shares owned at least three years to the ESOP and elect to defer tax on the gain by reinvesting the proceeds in shares of domestic corporations no earlier than three months prior to the sale and no later than 12 months after the sale (IRC §1042). Following the sale, the ESOP must own at least 30% of the outstanding stock of the company. The seller's basis in the "qualified replacement stock" (QRP) is the same as in the shares sold to the ESOP with gain deferred until the shares are sold. Sale to an ESOP allows an owner to diversify a portfolio that may be heavily invested in the closely held company. The QRP can also be used for gifts to AICR or to a charitable remainder trust.

Marla and Bill are shareholders of a corporation that maintains an ESOP. They sold shares of the company's stock to the ESOP, reinvesting the proceeds in qualified replacement property. The couple now wishes to create a unitrust, funding it with the QRP. The trustee would be under no obligation, express or implied, to sell the QRP. Marla and Bill asked the IRS if they would have to recognize deferred gain on the transfer of the QRP to the CRT. The IRS told the donors not to worry: recapture rules contained in IRC §1042 do not apply to a transfer of QRP that occurs by gift, and the IRS further ruled that there will be no gain on the transfer to the trust and no recapture (PLR 9438012).

Another reported use of ESOPs is for owners to transfer closely held C stock to a charitable remainder trust, make contributions to the ESOP and – without any prearrangement – have the ESOP purchase the company stock from the CRT.

Stock Subject to Restrictions

Careful planning is required where donors wish to transfer IRC §306 stock or restricted securities subject to SEC Rule 144/145. §306 stock produces ordinary income, rather than capital gain, upon a sale and deductions will be reduced under IRC §170(d)(1). Restricted stock, including "letter stock," control stock, private-placement stock and unregistered securities, is subject to transfer rules covering volume and timing of sales of the stock (including sales by charity), filing of information with the SEC and a joint two-year holding period for the donor and donee charity. Ask donors of closely held stock if it is restricted; if so, the donee charity should get advice from a securities expert before selling.

Gifts Involving Employee Stock Options

Companies often grant employees options to purchase company stock as a form of incentive compensation. These options may not be attractive as gifts to charity, either because they are nontransferable during life (incentive stock options) or because their exercise produces ordinary income ("nonstatutory" stock options). On the other hand, when employees acquire stock through the exercise of stock options, they may find it to be a good time for charitable gifts, either outright or in trust.

Gifts of S Corporation Stock

Effective January 1, 1998, charities became eligible to own S corporation stock [IRC §1361(c)(7)]. Prior to 1998, charitable gifts of S stock resulted in loss of S status for the donor's corporation. S corporations comprise nearly 47% of all corporations, so the number of potential donors is significant. Tax-wise, gifts of S stock may not be quite the opportunity charities would hope for, however. Items of income, loss, credit or deduction and any gain or loss on the sale or disposition of the stock will be taken into account in determining the organization's unrelated business taxable income (UBTI). Despite these tax disadvantages, most organizations are glad to accept S stock, on the premise that taxable income is better than no income at all – assuming there is a reasonable possibility of liquidating the stock soon after the transfer. Charitable remainder trusts remain ineligible shareholders in S corporations.

Clients should be informed that deductions for gifts of S stock may be less than the stock's appraised value. Donors must reduce deductions by the amount of ordinary income they would recognize if the stock were sold [IRC §170(e)(1)(A)]. These reductions follow rules applicable to gifts of partnership interests and take into account short-term capital gains, depreciation recapture and ordinary income property (inventory, for example). Minority discounts typically reduce deductions, as well.

Advisors who counsel charitable organizations should suggest that they review their gift acceptance policies and determine under what circumstances they will accept gifts of S corporation stock. Tax treatment of charities that accept gifts of S stock is unusually harsh. Every nickel of income generated by S stock will be UBTI, including items that are usually exempt, such as interest, dividends and rents. It's not the end of the world for a charity to have some unrelated business taxable income, or even owe tax when it sells S stock. Many organizations willingly pay taxes on for-profit activities, although too much UBTI could cost the charity its tax-exempt status. IRC §501(c)(3) status is not available to an organization that is operated for the primary purpose of carrying on an unrelated trade or business [Reg. §1.501(c)(3)-1(e)]. Corporate tax rates will apply to charities organized as corporations; trust tax rates to charitable trusts, such as community trusts. Gifts of S stock will involve many considerations, including some of the same questions that apply to gifts of partnership interests:

- What is the value of the stock? (Appraisals are required for gifts of closely held stock over $10,000.)
- Can the stock readily be redeemed or sold? Beware of prearranged sales. The IRS may take the position that, where there are only a handful of shareholders, any sale that takes place within a short time of the gift must have been prearranged.
- What is the donor's adjusted basis in the stock? A donor of closely held stock typically has a low basis, which will carry over into the hands of the charity and result in large gains when a charity sells. As noted earlier, part of the value of S stock may be ordinary income (appreciated inventory, for example), which will reduce the donor's deduction.
- Assuming the S stock can be sold or redeemed quickly, how much tax will the charity owe on the transfer? Corporations pay tax at regular rates on net capital gains, so the tax rate could be as low as 15% (total UBTI up to $50,000) or as high as 39% (on UBTI between $100,000 and $335,000). Charities organized as trusts will pay taxes at the highest individual rates on most income.
- If the organization has to hold the stock for any length of time, is it possible that it will have "phantom income"? (S corporation shareholders sometimes are taxed on income that was not distributed to them).
- How will a charity count a gift that is subject to UBTI, especially in view of tax that will be owed when the stock is sold?
- If an organization already has substantial UBTI (say, 30% of its gross revenue), will holding and selling S stock jeopardize its tax-exempt status?

S corporation stock won't fit into a charitable remainder trust [IRC §1367(c)]. But the IRS has ruled that a donor could transfer S stock to a grantor-type charitable lead annuity trust and charitable lead unitrust that will each pay a private foundation for six years (PLR 199908002).

This lengthy ruling provides a blueprint for donors and gift planners who may find it attractive to fund a charitable lead trust with stock in an S corporation (bearing in mind that private letter rulings may be relied upon only by the requesting taxpayer). Careful planning will be necessary, especially since the donor will be taxable on trust income. Will the trustee receive sufficient income from the S stock to pay the charities? Will the trustee be obliged to sell stock to make payments? To make distributions in kind? What if the trust receives excess income, saddling the donor with tax from the stock but none of its income? Assuming these important details can be worked out, the trust potentially could save a business owner both income taxes and transfer taxes and provide considerable benefit to a charity.

In another ruling, the IRS approved a charitable lead trust that would pay a 9.9% annuity for 15 years to various charities selected by the trustee. The trust would be funded with S stock, which would pass to two family trusts at the end of the 15-year term. The IRS ruled that the donor would be entitled to an income tax charitable deduction and a gift tax charitable deduction and that the trust would not be included in his estate if he died during the trust term. Neither the donor nor his wife may serve as trustee and his power to remove and replace the trustees is limited to naming successor trustees who are not related or subordinate to him (PLR 199936031).

TRANSFERRING CLOSELY HELD STOCK TO A CHARITABLE REMAINDER TRUST

With careful planning, a client can transfer closely held C stock to a charitable remainder trust with very favorable tax and financial consequences.

The trust will pay the client (or beneficiaries designated by the client) a fixed dollar annuity or a variable unitrust amount every year for life. The client will gain immediate tax savings because the present value of the Institute's deferred interest will qualify for a charitable deduction. Capital gains taxes will be avoided no matter how much the stock has appreciated in value. Certain corporate tax problems (e.g. the accumulation of income penalty tax) will be avoided or minimized, and potential gift and estate taxes will be minimized.

Clients also gain the great personal satisfaction of knowing that the charitable remainder trust will bring us closer to the day when the terrible disease of cancer is eradicated from our society.

There are three different scenarios possible when closely held stock is transferred to a charitable remainder trust.

First, the trust can hold the stock indefinitely or for a period of years. To accomplish this, the corporation must be able to pay dividends to the trust that equal or exceed the amount to be paid by the trust to the designated beneficiaries (or the donor may give other properties to the trust that will produce income or can be sold to make the required annuity or unitrust payments). The client could create an income-only unitrust which would permit the trust to hold the closely held stock even if it did not pay adequate dividends. The trust could be drafted to require the trust to make up all deficits in payments after the sale or redemption of the closely held stock. The trust could also start out as an income-only unitrust that later "flips" to a standard unitrust on the occurrence of a "triggering" event.

Second, the trust can sell the stock to an unrelated purchaser – without paying a capital gains tax – and invest the sales proceeds to pay an annuity or unitrust amount to the designated beneficiaries.

Third, the client's corporation can redeem the stock from the trust at its fair market value. The trust will then invest the redemption proceeds to pay an annuity or unitrust amount to the client or other beneficiaries.

(Presumably, an ESOP created by the corporation could purchase the stock from the trust with even more favorable tax consequences.)

Of course, all the challenges mentioned earlier in the discussion of outright gifts to the Institute – namely, valuation difficulties and cost; the need for a qualified appraisal; the possibility of adverse tax consequences to the donor if the trust is legally obligated to sell the stock to the corporation – also exist when stock is given to a charitable remainder trust.

There are also other possible problems and limitations. In unusual cases, transferring closely held stock to a charitable remainder trust can create an excess business holding problem or an unrelated business income problem. A redemption of stock by the corporation must be planned to avoid any problem of self dealing and any adverse tax consequences to the donor stockholder. S corporation shares cannot be transferred to a remainder trust.

All of these possible problems and limitations will be discussed later in this booklet. First, it may be helpful to look at the most common situations where a client can benefit by transferring closely held stock to a charitable remainder trust.

Selling Highly Appreciated Stock Without a Capital Gains Tax

Your client wants to sell the stock he or she owns in a closely held corporation. Because the stock has appreciated substantially in value, a personal sale of the stock would result in a huge capital gains tax. Solution: the client can transfer stock to a charitable remainder trust that will pay a good income for life and completely avoid any capital gains tax.

No matter how much the closely held stock has appreciated in value, transferring the stock to a charitable remainder trust is not a sale or exchange that will trigger a capital gains tax to the donor stockholder. The charitable remainder trust will take the donor's low cost basis. But a sale of the stock by the trust to the ultimate purchaser will not result in a capital gains tax because the trust is a tax-exempt entity. Every dollar of the sale proceeds will be available to provide an income to the donor and/or other designated beneficiaries for life and a later gift to the American Institute for Cancer Research.

The stockholder transferring closely held stock to a charitable remainder trust will also be rewarded with an immediate and significant income tax saving. The present value of the remainder interest given to the Institute will be deductible as a charitable contribution.

The exact amount of the charitable deduction will depend on a number of factors, including the age or ages of the beneficiaries and the nature and amount of the payments that are to be made each year to the beneficiaries.

The following table shows the approximate percentage of the value of the closely held stock given to a charitable remainder unitrust that will qualify for a charitable deduction. The deduction for an annuity trust will be somewhat greater at low payout rates and somewhat smaller at higher payout rates.

APPROXIMATE CHARITABLE DEDUCTION PERCENTAGES FOR A CHARITABLE REMAINDER UNITRUST

Age of	Percentage of value to be paid		
Beneficiary	5%	7%	9%
55	34.0%	23.7%	17.2%
60	40.2	29.5	22.4
65	46.9	36.1	28.5
70	53.9	43.5	35.6
75	61.2	51.3	43.6
80	68.4	59.6	52.3

Exact deduction amounts fluctuate monthly. Please feel free to call our Gift Planning Department at 1-800-843-8114 for the exact amount of the charitable deduction for any trusts your clients may want to consider.

A Charitable Remainder Trust Can Fit the Needs of the Donor. The donor can name anyone he or she wishes to receive payments from the trust for life. Several beneficiaries can be named to receive benefits concurrently or consecutively. Or the trustee can be given discretion to distribute the trust payments among a class of beneficiaries for a period of up to 20 years.

The annual payment can be a fixed dollar amount (an annuity trust) or a specified percentage of the value of the trust assets in each year (a unitrust). For example, the trust agreement could direct that 6% of the initial value of the stock transferred to the trust be paid to the donor for life and then to his spouse for her life. Or the annual payment could be a specified percentage of the value of the trust assets in that year. For example, the trustee could be directed to value the trust assets every year and pay 6% of the value of the trust in that year to the donor's daughter for as long as she may live.

The client can also use the trust to build up a high income that will be paid after he or she has retired (an income-only unitrust). This can be an excellent alternative for the closely held business owner who has a high present income and wants to be assured of a dependable income after retirement.

Here's an example of how an owner of closely held stock can benefit more from a charitable remainder trust than from a direct sale of the stock:

Peter and Penny each own one-half of the stock of a corporation valued at $2,000,000. Each has a cost basis of $120,000 in his or her stock. Penny transfers her stock to a charitable remainder unitrust that will pay her 7% of the value of the trust every year for as long as she may live. The trust sells the stock for $1,000,000 and, because it is tax-exempt, it keeps the full $1,000,000.

Assuming the trust has income and/or growth of 7% a year, Penny will receive $70,000 every year for her life. She will also gain an income tax savings of about $100,000 because of the allowable charitable deduction.

Peter sells his stock and incurs capital gains tax of $176,000. To have the same $70,000 annual income, Peter will have to dip into principal every year. The

$824,000 fund eventually will be completely exhausted.

Penny, on the other hand, will receive payments every year no matter how long she may live. She will also have the tax savings and the income from the tax savings. And at her death, a truly major gift of $1,000,000 – a gift that could save thousands of people from the tragedy of cancer – will pass to the American Institute for Cancer Research.

Problems and Limitations. Funding a charitable remainder trust with closely held stock that will be sold to an unrelated purchaser can present several possible problems and limitations.

First, if the amount of stock owned actively or constructively by the trust is 35% or more of the outstanding stock of the corporation, the stock will be an "excess business holding" of the trust. The charitable remainder trust must be planned and drafted in such a way that a prohibition of excess business holdings is not required. (See discussion on page 8.)

Second, the stock transferred to the trust must be less than 80% of the outstanding stock of the corporation. If the trust owns 80% or more of the stock of a corporation, any dividends it receives from the corporation will be unrelated business income, and the trust will lose its tax-exempt status. That could mean that the trust would have to pay capital gains tax when it sells the appreciated stock. (See discussion on page 8.)

Third, the purchaser of the stock must not be a "disqualified person" for purposes of the self dealing prohibition which must be written into every charitable remainder trust. For example, a spouse, child or brother of the donor stockholder could not purchase the stock from the trust. (See discussion on page 8.)

Fourth, in many cases, the closely held stock will not pay adequate dividends to make the annuity or unitrust payments. In that case, some provision must be made for giving the trust the liquidity to pay the annuity or unitrust amount to the donor stockholder, or other beneficiary, in the event there is a delay in selling the stock and obtaining cash to make the required payments. There will be no problem if adequate dividends can be paid by the corporation, if the donor can transfer liquid assets as well as the closely held stock to the trust, or if the donor is willing to take back some of the stock in payment of the annuity or unitrust amount. If none of the above is possible, it would be prudent to use an income-only or "flip" unitrust. (See discussion on page 8.)

Fifth, a qualified appraisal of the value of the stock transferred to the charitable remainder trust will be required if the value of the claimed charitable deduction exceeds $10,000. This can sometimes be an expensive cost to the donor stockholder, but it is generally a tax deductible cost. (See discussion on page 4.)

Corporate Cash Can Be Used to Give The Stockholder a Lifetime Income

The sole stockholder of a corporation wants to increase her income – or perhaps provide an income for her parents or other individuals. She can accomplish this by transferring a portion of her stock to a charitable remainder trust that will pay her – and/or other designated beneficiaries – a good income for life.

The charitable remainder trust will get cash or liquid assets from the corporation when it redeems the stock from the trust at its full fair market value. The cash or liquid assets so received will be invested and used to pay the required amount to the donor or other trust beneficiaries. The trust will continue during the life of the donor or other designated beneficiaries, and when all the beneficiaries have died, the principal will be paid to the American Institute for Cancer Research and used for important research or educational programs aimed at the prevention and treatment of cancer.

The donor will continue to own all the stock of the corporation because the redeemed stock will be retired by the corporation. Of course, the value of the corporation and the stock retained by the donor will be decreased by the corporation's payment of the redemption price.

Example of Redemption of Stock from Trust. Carl owns all the stock of a corporation. The stock has a value of $1,000,000. Carl transfers 20% of his stock to a charitable remainder trust that will pay him and his wife 7% of the value of the trust each year for as long as either may live. A few months later the corporation redeems the stock for $200,000. Assuming the trust has an income and/or growth of 7% a year, Carl and his wife will receive about $14,000 a year for as long as either of them may live. He will pay no capital gains tax and will significantly reduce his current income taxes because of the allowable charitable deduction.

The charitable remainder trust could be especially rewarding to Carl if: (1) he could not take additional compensation that would be deductible by his corporation; (2) the gift and redemption would minimize tax problems of the corporation; (3) he wanted to use an income-only unitrust with make up provisions to provide a high retirement income and immediate tax benefits; (4) he named his parents or other family members who were in low tax brackets as the beneficiaries of the trust; (5) his corporation could create an ESOP to redeem the stock from the trust; or (6) hastening the day when cancer would be eradicated from our society would be a source of great personal satisfaction.

Problems and Limitations on a Gift to a Trust and a Later Redemption. Many of the problems and limitations mentioned in the preceding section should be considered in transferring closely held stock to a charitable remainder trust with the thought that it will be redeemed by the corporation.

Certainly, the trust should be drafted to avoid including a prohibition against excess business holdings. Even a small interest can be an excess business holding within the constructive ownership rules of IRC §4943. And the trust should not own as much as 80% of the stock of the corporation.

The corporation will be a disqualified person within the meaning of the prohibition against self-dealing. However, a special rule permits the corporation to redeem stock from the trust provided the redemption is at full fair market value and the offer to redeem is made to all stockholders. The redemption price cannot be paid in installments, but the corporation can redeem the stock in incremental portions. (See discussion on page 9.)

From a practical viewpoint, the corporation must have adequate liquid assets to redeem all or most of the stock. It cannot transfer appreciated property to the trust in exchange for the stock without incurring corporate capital gains tax on the difference between its cost basis and the fair market value of the property.

Corporate Sale of Assets Prior to Redemption

The stockholders of a closely held corporation will face a serious tax problem when: (a) the corporation owns property that has appreciated substantially in value and (b) the value of their stock is also highly appreciated. In this situation, the liquidation of the corporation will result in both a corporate tax and an individual stockholder tax.

Assume that the only substantial asset of a corporation is a parcel of real property that is worth $1,000,000. The corporation's cost basis is $600,000 and the sole stockholder has a cost basis of $300,000 in his stock. When the corporation sells the real property for $1,000,000, it must pay a corporate tax on the $400,000 profit (approximately $140,000). And when the corporation redeems the sole shareholder's stock for $860,000, the stockholder will incur capital gains tax of $112,000. The sole stockholder will realize only $748,000 for stock valued at $1,000,000.

The result will be the same if the corporation transfers the real property to the stockholder in redemption of the stock because the redemption will be treated as a sale of the property by the corporation.

Transferring the stock to a charitable remainder trust would avoid capital gains tax to the stockholder. The corporation can use the after-tax proceeds of the sale of the real property ($860,000) to redeem the stock from the charitable remainder trust and, because the trust is a tax-exempt entity, it will retain every dollar of the redemption proceeds. The full $860,000 can be invested and used to provide a high lifetime income for the stockholder and/or other designated beneficiaries of the trust. Caution: The stock gift must occur *before* any plan of liquidation is adopted.

Liquidation of Corporation by Charity?

Owners of C corporations – particularly those with personal holding companies – sometimes propose contributing their businesses to charitable remainder trusts, or perhaps outright to a charity, with the expectation that the trust or charity will liquidate the corporation. Two levels of taxation ordinarily occur upon liquidation: the owner incurs capital gains tax on redemption of his stock in the corporation, and the corporation is taxed when it sells or distributes its assets in a complete liquidation of the company.

The IRS has issued final regulations requiring recognition of gain by a C corporation in most cases where a tax-exempt organization acquires all or substantially all of the corporation's assets [Reg. §1.337(d)-4]. The regulations are effective for transfers after January 28, 1999. Under the 1986 Tax Reform Act, corporations must recognize gain or loss when appreciated or depreciated property is distributed or sold in a complete liquidation (IRC §§336, 337). The regulations, first proposed in January 1997, foreclose attempts to get around the corporate tax by transferring corporation assets to tax-exempt entities. No tax is imposed as to transferred assets used by the tax-exempt organization in an activity subject to the unrelated business income tax [IRC §511(a)].

Business owners can still transfer all their shares in a corporation to charity or a charitable trust and receive a deduction based on the fair market value of their stock, without having to pay capital gains taxes. Therefore, one layer of tax is avoided. But when the charity or trust liquidates the corporation, the corporation will be taxed, which will reduce the amount remaining for the charity or charitable trust.

Increasing Corporate Control of Family Members without a Gift Tax

A father owns 60% of the stock of a $4 million family corporation. His children, who work for the corporation, own the other 40%. Father wants to pass control of the corporation to his children. His stock interest is worth $2,400,000. Rather than making gifts of stock to his children, which would be subject to the federal gift tax, father can give a 21% stock interest worth $840,000 to a charitable remainder trust that will pay a good income to him and his wife for as long as either may live. (The stock transferred to the trust will completely escape gift and estate taxes because the full amount of the gift will qualify for a marital or charitable deduction.)

The corporation redeems the stock, paying $840,000 to the trust – all with absolutely no capital gains taxes. The stock is retired by the corporation.

Father is assured of a dependable income. He gains a current charitable contribution deduction for the value of the remainder interest given to the American Institute for Cancer Research, and his children now have a controlling interest in the corporation. (After the stock has been redeemed, the children will own slightly more than 50% of the outstanding stock.)

This plan could be even more tax advantageous if the corporation had an employee stock ownership plan (ESOP) and the children were major participants in the plan. The ESOP could, perhaps, borrow part of the funds required to redeem the stock (at favorable interest rates) and repay the loan with annual tax deductible contributions from the corporation.

All the problems and limitations mentioned in the prior section would, of course, have to be considered in planning and drafting a charitable remainder trust designed to pass ownership and control of the corporation to family members.

Closely Held Stock Can Be An Excess Business Holding

Although it is not necessary to include the private foundation prohibition against excess business holdings in a typical charitable remainder trust, the prohibition can sometimes present a problem in planning and drafting the trust.

Essentially, a charitable remainder trust would have an excess business holding if it owned, actually or constructively, 20%, or sometimes 35%, of the outstanding voting stock of a corporation. The trust would be required to dispose of the excess business holding within a certain period of time, and this could require a forced sale or a sale that would be detrimental to the corporation.

The prohibition against excess business holdings is mandatory in a charitable remainder trust only if a distribution of income might be made to a charitable beneficiary prior to the termination of the trust. This would happen if the trust agreement directed a partial distribution after the death of one beneficiary and was to continue for a second beneficiary or if the trust was to continue for the benefit of the charitable remainderman.

A potential drafting trap would be to use the IRS safe harbor trust forms for a trust funded with closely held stock. All the safe harbor forms do prohibit excess business holdings. Again, this prohibition is not required in the typical charitable remainder annuity trust or unitrust.

Holding a Controlled Corporation Causes Unrelated Business Income

A charitable remainder trust loses its tax-exempt status if it has unrelated business income. The result is that the trust will be taxed as a complex trust and realize a taxable capital gain if it sells appreciated closely held stock either to the corporation or to an unrelated party. A special provision of IRC §512 provides that a charitable remainder trust will have unrelated business income if it receives dividends from a corporation in which it owns 80% or more of the outstanding voting stock.

As a practical matter, a charitable remainder trust should never be given more than 79% of the stock of a corporation. This limitation on the percentage of stock a charitable remainder trust may own certainly creates a problem where a sole stockholder wants to sell his or her entire interest to an unrelated party.

The Prohibition Against Self-Dealing And Closely Held Stock

Every charitable remainder trust agreement must prohibit self-dealing. This means the trust cannot sell, exchange or lease property to the donor, a member of the donor's family or a corporation, partnership or trust in which the donor or a member of his family owns an interest of 35% or more.

Clearly, a charitable remainder trust cannot sell closely held stock to family members or to corporations in which the donor or a family member has a substantial interest.

Fortunately, a major exception permits a corporation to redeem its stock from a charitable remainder trust even though it is a "disqualified person" for purposes of the self-dealing prohibition. The corporation must redeem the stock from the trust for its full fair market value and must offer to redeem the same class of stock from all other stockholders.

Choosing the Trust Arrangement For a Gift of Closely Held Stock

The choice of the form of charitable remainder trust will generally depend on the personal objectives of the donor. In some cases, an annuity trust will produce the largest charitable deduction for approximately the same payout to individual beneficiaries. Or the unitrust may offer the potential for a payout that will increase over the years and be an effective hedge against inflation. An income-only unitrust may be preferred because it can facilitate building a high retirement income for the client and/or other designated beneficiaries.

When a charitable remainder trust is to be funded with closely held stock that will be sold to an unrelated purchaser and it seems that it may take some time to negotiate a sale (or when the stock will be redeemed only after the corporation is able to sell certain assets), an income-only unitrust or "flip" unitrust may be the preferred arrangement. With this form of trust, it will not be necessary to make any distributions other than whatever income the trust may earn until the stock is sold. Adding a make-up provision to the trust agreement will permit the trust to distribute income earned in excess of the specified percentage of value after the closely held stock has been sold to make up for payments not made in the years before the stock was sold. A "flip" provision would permit the trust to begin as a net-income trust, then change to a standard payout unitrust in the year after the closely held stock is sold or redeemed (a "trigger event").

Drafting a Trust Funded With Closely Held Stock

Whether your client chooses an annuity trust, a unitrust or an income-only unitrust, an IRS safe harbor trust form can be used, but only with several changes.

First, unless your client has a different objective, there should be a clear statement that the annual, semiannual or quarterly payments are to be made at the end of the period. In the absence of this clear statement, the trust will probably be interpreted as requiring payment at the beginning of each period.

Second, if an annuity trust is chosen by the client, the annuity should generally be expressed as a specified percentage of the initial value of the trust rather than as a specific dollar amount.

Third, the prohibition against excess business holdings should be omitted from the trust agreement.

Fourth, the trust agreement should require that the American Institute for Cancer Research, and/or other charitable remainderman, be qualified under IRC §170(b)(1)(A) as well as under §§170(c), 2055(a) and 2522(c).

Fifth, the principal and income of the trust should be distributed to the American Institute for Cancer Research at the death of the income beneficiaries rather than having the trust continue for the benefit of the Institute. And there should be no distribution of income to a charitable beneficiary until after the termination of the trust.

Sixth, consideration should be given to adding specific trustee powers – including the right to hold, deal with, vote, sell or trade closely held stock.

You should generally recommend an income-only unitrust or "flip" unitrust to a client if it seems that the closely held stock may not be sold in time to generate the cash required to make the annuity or unitrust payments. The income-only unitrust agreement should generally contain a make-up provision and a direction that post-contribution capital gains are to be considered income for trust accounting and distribution purposes. That way, any deficits arising because the trust did not have income equal to the specified percentage of value can be made up when the stock is sold with a resulting capital gain.

Closely-Held Stock in a Charitable Lead Trust

Capital gains taxes discourage gifts followed by redemption to lifetime charitable lead trusts which, unlike charitable remainder trusts, are not tax exempt. Testamentary charitable lead trusts currently pose no such problems because stock receives a step-up in basis, at least through 2009.

What if a lifetime charitable lead trust retains closely held stock? Retention works in the unusual case that the stock pays regular dividends and, if that's the case, significant gift tax savings may be available. Retention also may work where the trust is structured as a grantor trust intended to provide the donor with both income tax deductions and gift tax deductions (a so-called intentionally defective grantor trust).

The plan would be for the business owner to transfer stock to a lead annuity or unitrust that pays income to charity, remainder to children. Stock is divided into two gifts – one charitable and one private – for transfer tax purposes, and the gift tax charitable deduction reduces the taxable gift to children. Furthermore, some or all of the future appreciation can pass to children free of federal transfer tax (note that capital gains taxes are still a problem when children sell). Note also that, under IRC §4947(b)(3)(A), the value of the gift to a charity cannot exceed 60% of the value of the stock placed in trust.

The trust can be structured as a grantor lead trust by allowing a disinterested party to substitute other assets for assets contained in the trust. Another option is to give the trustee the power to name additional charities as income beneficiaries. Result? The donor receives an income tax charitable deduction in addition to the gift tax charitable deduction. To minimize income taxes to the grantor, such a trust needs to be funded with tax-free investments or growth stock. Closely held stocks generally provide growth only. To make the payout, the trustee would either seek redemption of some stock from the corporation (just enough to make the payout to the charity), or perhaps distribute stock outright to the charity as payment "in kind." The trust would realize gain that would be passed through and taxed to the donor. But the gain likely will be long-term, and capped at a maximum rate of 20%. The donor will have realized income tax charitable deduction savings, however, in a 40% to 50% bracket (state and federal). See PLR 9716023, which approved a lead trust funded with partnership units whose underlying assets were marketable securities.

The challenge with the foregoing arrangement is determining how much stock must be redeemed, sold or distributed to a charity in kind to satisfy the annual annuity or unitrust payments to the charity. It's also uncertain exactly how much closely held stock will remain for distribution to the trust remainder beneficiaries at the termination of the trust.

The War Against Cancer

When you have the occasion to draft a trust or a bequest for a client who wants part of his or her estate to support the war against cancer, our correct legal name is:

"The American Institute for Cancer Research, a not-for-profit corporation located in Washington, DC."

Please feel free to contact our Gift Planning Office for additional information about the mission and the future plans of the American Institute for Cancer Research.

Our Gift Planning Office will be pleased to help you plan a trust or bequest that will accomplish the specific objectives of your client. We can also provide the exact tax consequences of any trust arrangement a client may want to consider. There is no cost or other obligation for this service.

Information for the Attorney or Advisor

- AICR's official name:
  The American Institute for Cancer Research
- AICR's mailing address:
  1759 R Street, NW
  Washington, DC 20009
- AICR's phone number:
  202-328-7744 or 800-843-8114
- AICR's identification:
  A not-for-profit organization under Section 501(c)(3)
  of the Internal Revenue Service Code
- AICR's tax-exempt IRS number:
  52-1238026

The information and examples provided in this booklet are for information and discussion purposes only. The examples are hypothetical, and the facts and tax consequences of individual transactions may vary from person to person. Each estate planning professional must independently determine and evaluate the tax and financial consequences of each individual situation.

Gift Planning Office

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