

PROFESSIONAL TAX & ESTATE PLANNING NOTES

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2 Considerations in Making Charitable Gifts of Interests in Pass-through Entities

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Other than cash, publicly traded stock is the most common property contributed to charity. But, as we noted in the previous issue of *Professional Notes*, charitable gifts of unusual assets can also offer donors a tax-efficient way to support charity. For example, donors with significant wealth in closely held businesses or alternative investments, such as hedge funds and private equity funds, may be interested in using those assets as a vehicle for their philanthropy.

This article addresses the tax considerations for charitable contributions using closely held businesses or alternative investments structured as “pass-through entities”—for the most part, as limited partnerships or limited liability companies (“LLCs”) that have not chosen

to be taxed at the entity level as Subchapter C corporations but instead “pass through” each partner or member’s allocable share of net income or gain.¹ This article on pass-through entities is the second in a three-part series about charitable gifts using unusual and hard-to-value assets. It builds on the general concepts considered in the first issue: *Charitable Gifts Using Illiquid Securities* (March 2010).

Charitably inclined individuals who hold interests in a partnership might consider contributing all or a portion of such interests to charity, especially if the value of the partnership has increased and is likely to be bought out. However, these gifts present novel tax issues for the charity and the donor and therefore require careful consideration in each particular situation.

¹ Owners of interests in LLCs are referred to as members. Throughout this article, the word “partner” is used to include LLC members, and the term “partnership” to include LLCs. Special rules may apply to S corporation interests, which are separately discussed in the March issue, and to REITs, which are discussed briefly in this issue.

General Overview

Subchapter K of the Internal Revenue Code (the “Code”)² contains an extensive set of rules that govern partnerships. Under Code Section 702(b), the character of any item of income, gain, loss, deduction, or credit included in a partner’s distributive share from partnership activities is determined as if such item were realized directly or incurred in the same manner as incurred by the partnership.

It should be noted that The New York Community Trust, like most charities, will not accept a general partnership interest; the for-profit activity generally is inconsistent with our charitable mission and places charitable assets at risk for the liabilities of the partnership.

Charitable Income Tax Deduction

An individual who contributes corporate securities, partnership interests, or other intangible property to a public charity, such as The Trust, generally receives a tax deduction equal to the fair market value of the property, provided it is “long-term capital gain property,” i.e., a capital asset that has been held for more than a year. Fair market value of a partnership interest ordinarily will be the difference between the donor’s share of the fair market value of partnership assets and his share of partnership liabilities, whether recourse or nonrecourse.

However, there is an important limitation to the extent the partnership owns ordinary income assets, such as unrealized receivables or inventory items. Those assets—sometimes called Code Section 751 assets or “hot assets”—may be included in the donor’s deduction only to the extent of their basis in the partnership. This is consistent with the general limitations under Code Section 170(e) on direct donations of ordinary income property.

Under the partial interest rules generally applicable to the charitable deduction, the donor of a partnership interest must give charity his entire interest in the

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property or an undivided portion of that entire interest; otherwise, no deduction will be allowed. A gift of an undivided portion of a partnership interest must include a *pro rata* share of all attributes of the partnership interest, such as capital, allocation of income and expense, and distributions.

Recognition of Gain

A charitable contribution of a partnership interest subject to liabilities may be treated as a deemed bargain sale, resulting in the donor’s recognition of taxable gain. The donor will be deemed to have sold his partnership interest to the extent of his allocable share of liabilities, and his basis in the partnership will be allocated *pro rata* between the amount deemed sold and the amount treated as a gift to charity.

Passive Activity Losses

Passive activity losses that arise from activities in which a partner did not materially participate (e.g., most rental activities) may be claimed as tax losses by the partner only to the extent of income or gain from those activities or upon a final disposition of the passive activity. A donor’s charitable contribution of a partnership interest is not a qualifying disposition for these purposes and will not enable the donor to take a deduction for suspended passive activity losses. Instead, the suspended losses increase the donor’s basis when the partnership interest is contributed to charity. Although this increased basis may reduce the donor’s taxable gain in cases where debt within the partnership results in a deemed bargain sale, this increased basis is essentially without value to the donor if the partnership has no liabilities or if its liabilities are very small.

In all events, an individual with suspended passive activity losses from a partnership should study the numbers carefully. He may be better off selling his partnership interest, deducting the passive activity loss on his personal return, and then donating the net proceeds of sale to charity.

²All “Code” references are to the Internal Revenue code of 1986, as amended, and all “Treas. Reg. Section” references are to the regulations promulgated thereunder.

Timing of Charitable Contribution

The admission of a new partner generally is governed by the limited partnership agreement or, in the case of an LLC, the LLC operating agreement. Where the agreement is silent, state law will control. For example, in the case of a limited partnership formed under New York State law, the substitution of a new partner requires consent of both the new partner and the existing partners. Under a typical limited partnership agreement, the contribution of a partnership interest would not be effective until accepted by the charity and consented to by the general partner.

Factors That May Affect a Charity's Willingness to Accept a Gift of a Pass-Through Interest

Unrelated Business Income Tax. Although generally exempt from tax, charities pay tax on their unrelated business taxable income ("UBTI"), which is net income derived from any trade or business that is not substantially related to the charity's exempt purpose. As a result, if a charity becomes a partner in a partnership that is engaged in an unrelated trade or business, the charity will include in UBTI its share of the partnership's income or gain derived from any unrelated trade or business, regardless of whether cash is distributed. In addition, under the debt-financed income rules of Code Section 514, UBTI also may arise as a result of indebtedness held in the partnership. A charity is unlikely to accept an interest in a partnership that will produce UBTI unless it can be assured of receiving sufficient cash distributions from the partnership to pay the resulting tax liability.

Because hedge funds often raise money through borrowing, they are likely to produce UBTI as a result of the debt-financed income rules. To enable charities to invest in alternate investments such as hedge funds without incurring significant tax liabilities, U.S. hedge funds commonly create foreign corporations called "blocker corporations" through which charities can invest in limited partnership hedge funds without incurring UBTI. The dividends that charities receive from these foreign blocker corporations are not subject to the debt-financed income rules and are not UBTI. Many charities include hedge

funds in their portfolios, investing through foreign blocker corporations. A donor who wishes to contribute a limited partnership interest in a hedge fund to charity may want to consider whether the interest can be converted to an interest in the offshore blocker corporation before donating the interest to charity. However, if the donor himself contributes his interest to a non-U.S. blocker corporation, he will recognize gain under Code Section 367 and face IRS reporting obligations as well. If the charitable recipient were to contribute the hedge fund interest to a foreign blocker corporation, it likely would have gain that would be treated as debt-financed UBTI.

Other Potential Liabilities. Partnership agreements commonly include provisions for capital calls. This is particularly true in venture capital or private equity funds where investors pay in their capital commitments over a period of years. A charity receiving a contribution of a partnership interest will want assurance that it will not be subject to any capital call provisions.

Tax Shelter Restrictions. Investors in certain tax shelters and "reportable transactions" are required to disclose their participation in those transactions. A reportable transaction is any transaction where information must be included with a return or statement because the IRS has determined that the transaction is of a type that has a potential for tax avoidance or evasion.

The failure to include information about a reportable transaction is subject to penalties. In the case of a charity, the penalty is significant: \$50,000 for a reportable transaction and \$200,000 if the reportable transaction is one that the IRS has publicly identified (known as a "listed transaction").

Before accepting a gift of a partnership interest, particularly an interest in a partnership structure with multiple layers, a charity will want to assess the activities of the partnership at each level. The partnership's transactions will be attributed to the charity if it accepts the interest. The charity may want representations from the partnership that it is not engaged in any reportable or listed tax shelter transactions.

Other Considerations

Transferability. Partnership interests generally are not freely transferable. The contributing partner and the charity will want to confirm that all requirements for transfer under the partnership agreement are met.

Valuation. A contribution of a partnership interest worth more than \$5,000 will require a written appraisal from a qualified appraiser, unlike the case of a contribution of publicly traded securities.

Publicly Traded Partnerships. Under Code Section 7704, a publicly traded partnership (“PTP”) is a partnership whose interests are traded on an established securities market or are readily tradable on a secondary market. A PTP is treated as a corporation unless 90 percent or more of its gross income in the current taxable year and each preceding year is “qualifying income.” For this purpose, qualifying income includes interest, dividends, real property rents, gain from sale or disposition of real property, and gain on sale or disposition of a capital asset held for production of such income. If 90 percent of a PTP’s gross income is qualifying income, the PTP is taxed as a partnership. A PTP that is taxed as a partnership may raise UBIT issues for a charity, although generally speaking, the enumerated types of income do not constitute UBTI unless debt financing is involved.

If the PTP units are valued in excess of \$5,000, a donor will need to evaluate whether the contribution of those interests requires a qualified appraisal. Although a qualified appraisal is not required for a gift of “publicly traded securities,” that term is limited to the stock of corporations. Units of a PTP treated as a corporation under Code Section 7704 are arguably equivalent to publicly traded stock of a corporation. However, the applicability of the qualified appraisal rules to those units does not appear to be settled.

Contribution of Assets by the Partnership. Instead of a partner donating his partnership interest to charity,

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the partnership itself can donate assets to charity. Each partner’s basis in his partnership interest will be reduced by his share of the partnership’s basis in the property contributed, because charitable deductions are separately allocated to and deductible by the partners under Code Section 702.

The IRS has noted that, where the property is long-term capital gain property, limiting the basis deduction to the share of the partnership’s basis in the assets preserves the intended benefit of providing a deduction for the fair market value of appreciated property without recognition of the appreciation.

REITS. A real estate investment trust (“REIT”) is a corporation that owns and manages a portfolio of real estate properties and mortgages. Like mutual funds, REITs are entitled to a deduction for dividends paid and generally are subject to tax only on undistributed income. As a result, investors in REITs are generally subject to only a single level of tax with respect to their investments and, as such, resemble partnerships. A REIT interest may or may not be a suitable charitable gift because, although the income received from a REIT is treated as dividend income, it may in rare cases generate UBTI because of debt financing. However, regular dividend distributions received from REITs, as well as gain from a disposition of a REIT interest, are exempt from the UBTI rules. A donor interested in contributing his REIT interest to charity should determine whether the REIT’s activities might have negative tax consequences for the charity. The donor should also refer to the REIT’s prospectus to determine whether the charitable contribution would be permissible in the first instance.

Carried Interests. A carried interest in a partnership refers to an interest in partnership profits received in exchange for services, typically without any capital contribution by the provider of those services. Under current law, the carried interest is treated as a capital asset and as such is subject to favorable capital gains tax rates upon sale or realization. This rule has become

controversial, particularly for carried interests held by investment managers of hedge funds and private equity or venture capital funds. Proposed legislation would change that characterization and treat a portion of a service partner's carried interest as ordinary income.³ However, "qualified capital interests"—meaning capital invested in a partnership by a service partner if the investment is made on the same terms as capital investments by partners who do not provide services to the partnership—would still enjoy favorable treatment as a capital asset.

If the legislation becomes law, it appears likely that a service partner's charitable contribution of his carried interest (unless it is a qualified capital interest) would not give rise to a full fair market value deduction because only a portion of it would be treated as a gift of a capital asset. Donors considering contributing a carried interest to charity should consult with their tax advisors and the charity about the possible tax consequences.

Conclusion

Tax treatment of a contribution of pass-through interests to charity depends heavily on the underlying assets and activities of the pass-through entity. If the entity has certain types of property, the donor may not be able to take the full fair market value as a deduction, which may defeat the purpose of donating the interest. If the pass-through entity could generate more than insignificant amounts of UBTI from its assets or activities, the charity may not want to accept the interest. Therefore, before contributing such an interest to charity, a donor must thoroughly understand the pass-through entity's structure and should become familiar with its governing documents and activities. The donor should also have a conversation with the charity in order to better understand the charity's needs and possible limitations around such a contribution.

If any of your clients are considering contributing pass-through interests to The New York Community Trust, we can work with you and them to develop a plan designed to accomplish their philanthropic goals and achieve optimal tax results.

For further reference see:

Code Section 165(g)(2): Securities defined
Code Section 170: Charitable contributions and gifts
Code Section 170(f)(3)(A): Denial of deduction for certain contributions of partial interests in property
Code Section 469: Passive activity losses and credits limited
Code Section 469(k)(2): Publicly traded partnership definition
Code Section 511: Imposition of tax on unrelated business income of charitable organizations
Code Section 512: Unrelated business taxable income
Code Section 513: Unrelated trade or business
Code Section 514: Unrelated debt-financed income
Code Sections 701-704: Partners and partnerships
Code Section 751: Unrealized receivables and inventory
Code Section 752: Treatment of certain partnership liabilities
Code Section 856: REIT definition
Code Section 1011(b): Bargain sales
Code Section 6111: Disclosure of reportable transactions
Code Section 6707A: Penalty for failure to include reportable transaction information with return
Code Section 7704: Publicly traded partnerships treated as corporations
Treas. Reg. Section 1.170A-1: Charitable contribution deduction
Treas. Reg. Section 1.170A-7: Contributions not in trust of partial interests in property
Treas. Reg. Section 1.704-1: Partner's distributive share
Treas. Reg. Section 1.752-1: Treatment of partnership liabilities
Treas. Reg. Section 1.1001-1(e)(1): Part sale part gift transfers
Treas. Reg. Section 1.6011-4: Disclosure requirement of participation in certain transactions.
Buehner v. Commissioner, 65 TC 723 (1976)
Rev. Rul. 60-352, 1960-2 CB 208
Rev. Rul. 66-106, 1966-1 CB 151
Rev. Rul. 75-194, 1975-1 CB 80
Rev. Rul. 96-11, 1996-1 CB 140
PLR 200251018
New York Partnership Law Section 40
H.R. 4213, http://waysandmeans.house.gov/media/pdf/111/HWC_711_xml.pdf

³H.R. 4213, the "American Jobs and Closing Tax Loopholes Act," would treat 50 percent of a service partner's carried interest as ordinary income through 2012, and 75 percent as ordinary income thereafter.

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About The Trust

For 86 years, The New York Community Trust has served the needs of donors and nonprofits in the New York area. One of the oldest and largest community foundations, The Trust is an aggregate of funds created by individuals, families, and businesses to support the voluntary organizations that are crucial to a community's vitality.

Grants made from these funds—which now number nearly 2,000—meet the needs of children, youth, and families; support community development; improve the environment; promote health; assist people with special needs; and bolster education, arts, and human justice.

In addition to reviewing proposals from nonprofit agencies and responding to the grant suggestions of donors, The Trust is alert to emerging issues and develops strategies to deal with them, works collaboratively with other funders and with government, and gets out information to the public. Recent initiatives have included programs that address youth violence, managed health care, immigration, child abuse, and public school reform.

The Trust is governed by a 12-member Distribution Committee composed of respected community leaders. Its staff is recognized for its expertise in grantmaking, financial administration, and donor services. Local divisions are located on Long Island and in Westchester. In 2009, The Trust made grants of \$123 million from \$1.7 billion in assets.

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