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Planning a Bequest of a Closely-Held Business Interest to a Private Foundation

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Private foundations are an appealing planning tool for the charitably inclined closely held business owner. A gift or bequest to a client's private foundation allows the client or his estate to obtain an upfront tax deduction, while allowing the family to continue to control the asset.

However, when the bequest is an interest in a closely held business, the private foundation excise tax rules may prohibit the foundation from owning the interest long term. As such, a plan to bequeath an interest in a closely held business to a private foundation necessarily requires consideration of whether the foundation will need to divest itself of the interest after the client's death, and if so, how that divestment will occur.

The federal government subjects private foundations to strict administration rules, frequently referred to as the private foundation excise taxes. As opposed to a public charity, which receives contributions from a wide base of donors, private foundations generally receive contributions from only one donor, or from several donors who are members of the same family. Frequently, the donor and the donor's family frequently control the foundation. Because the donors are also the foundation managers, historically there was a perception of widespread abuses of the private foundation structure. As a result, Congress enacted the excise tax regime, subjecting private foundations to strict rules intended to ensure that the foundation's assets are used only for charitable purposes.

The excise taxes are implicated when a "disqualified person" enters into a transaction with the foundation. Under IRC §4946, a substantial contributor to the foundation is a disqualified person. So are foundation managers and owners of more than 20 percent of the total combined voting power of a corporation that is a substantial contributor to the foundation, owners of more than 20 percent of the profits interest of a partnership that is a substantial contributor to the foundation, or owners of more than 20 percent of the beneficial interest of a trust or unincorporated enterprise that is a substantial contributor to the foundation. In addition, family members[1] of a substantial contributor, a foundation manager, or 20 percent owners are all disqualified persons.

Certain entities are also considered disqualified persons. A corporation will be considered a disqualified person if more than 35 percent of the voting power is owned, directly or indirectly, by a disqualified person. A partnership is a disqualified person if more than 35 percent of the profits interest is owned, directly or indirectly, by a disqualified person. A trust or estate is a disqualified person if more than 35 percent of the beneficial interest is held, directly or indirectly, by a disqualified person. In addition, the I.R.C. §267(c) constructive ownership rules apply for purposes of analyzing the 20 percent and 35 percent ownership thresholds.

If a client intends to leave an interest in a closely held business to his or her private foundation, the planner should analyze whether the bequest would cause the foundation to have "excess business holdings" pursuant to §4943 of the Code. A private foundation and its disqualified persons, collectively, may not own more than 20 percent of the voting stock of a corporation. This number is increased to 35 percent if the foundation and all of the disqualified persons, acting together, do not effectively have control over the corporation. So long as disqualified persons do not own more than 20 percent of the voting stock (or 35 percent, if disqualified persons do not effectively have

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control over the corporation), a private foundation may own an unlimited amount of a company's nonvoting stock. Similar rules apply to interests in partnerships and limited liability companies.

Several exceptions apply to the excess building holdings rules. First, an interest in a business that is "functionally related" to the mission of the foundation will not be considered excess business holdings. In addition, a foundation will not run afoul of the excess business holdings rules if 95 percent or more of the gross income of the business is passive.

Passive income includes dividends, interest, and royalties, and in many cases, rent. Finally, the Code provides a de minimis exception for ownership, granting a reprieve from the excise tax for a private foundation that does not own more than 2 percent of the voting stock and not more than 2 percent in value of all outstanding shares of all classes of stock in the business.

If the private foundation exceeds the percentage holdings noted above, the private foundation has "excess business holdings" and must divest itself of the excess holdings or face an excise tax equal to 10 percent of the value of the excess business holdings. If the tax is assessed and the excess business holdings are not disposed of, the tax increases to 200 percent.

For illustrative purposes, assume that a client owns 100 percent of a family business. At death, he intends to give 100 percent of the voting stock to his child who works in the business; 60 percent of the non-voting stock to his children, equally; and 40 percent of the non-voting stock to the private foundation that he created and funded during his lifetime. His motivations are both charitable and tax driven, as he hopes that the charitable deduction will negate the need to raise liquidity to pay estate taxes, allowing the business to remain in the family for the next generation.

This bequest will cause the foundation to have excess business holdings. The client is a substantial contributor to the foundation, and as such, he and his children are all disqualified persons. The foundation and all disqualified persons may not own more than 20 percent of the outstanding voting stock in the corporation. Because the one child intends to retain 100 percent of the voting stock, and the foundation's holdings exceed 2 percent of the value of the business, the foundation will have to divest itself of the bequest of 40 percent of the non-voting stock.

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Having determined that the foundation will have excess business holdings, the client and planner should consider the plan for divestment. If the foundation has excess business holdings and no way out, a charitable deduction may have saved the company from a fire sale to pay the estate tax only to result in a company that may be seriously stressed by, and may not survive, an excess business holdings crisis.

A sale or redemption in the estate would be the simplest way to cure the excess business holdings problem. Assuming the executor can overcome the legal impediments to a sale or redemption, as discussed further below, there may still be major practical impediment if the client did not plan in advance for the divestment: A sale or redemption is only possible to the extent that there is readily available cash or other assets. If a redemption is desired, the company may have to deplete its cash on hand or exhaust its line of credit in order to complete the redemption, which could cripple the ability of the company to continue to operate on an ongoing basis. Or, if the preferred route is for the decedent's family to purchase the stock, consideration should be given as to how those individuals will fund the purchase price.

If a sale to the client's children is contemplated, the excess business holdings must be sold by the estate, as opposed to by the foundation. As a result, the time frame for the sale is limited to the years immediately following the client's death. The sale must occur in the estate because a child of a substantial contributor is a disqualified person, and the self-dealing rules found in I.R.C. §4941 flatly prohibit the sale of foundation assets to disqualified persons, even if the sale is for fair market value.

Similarly, if the plan is for the company to redeem the excess business holdings, the redemption must occur in the estate and not in the foundation. In this example, the company itself is also a disqualified person, generally making the redemption a prohibited I.R.C. §4941 self-dealing transaction, too. There is one exception to the redemption prohibition: A redemption is not considered self-dealing if all of the securities of the same class as that held by the foundation are redeemed on the same terms, and the terms provide for receipt by the foundation of no less than fair market value. In many cases, such a widespread redemption will be neither feasible nor desirable.

The executor's sale to a disqualified person, or redemption by a disqualified person, is considered an indirect act of self dealing, and therefore is only permissible if the executor meets the requirements laid out in Treasury Regulation §53.4941(d)-(b)(3). First, the executor must possess a power of sale with respect to the stock, have the power to reallocate the stock to another beneficiary, or be required to sell the property under the terms of any option subject to which the property was acquired by the estate or trust. In addition, the foundation must receive an amount equal to or greater than the fair market value of the foundation's interest or expectancy in such stock at the time of the transaction, and the transaction must be approved by the probate court having jurisdiction over the estate, the trust, or the private foundation.[2] The transaction must occur before the estate or trust is considered terminated for federal income tax purposes. And finally, the transaction must result in the foundation receiving either an interest at least as liquid as the one it gave up or an asset related to the active carrying out of the foundation's exempt purpose.

If the executor does not take advantage of this procedure in the estate and instead transfers the excess business holdings to the foundation, the foundation will be stuck with limited options to rid itself of the excess, such as by distributing the shares to a public charity or by selling the shares to an unrelated third party. In addition, the foundation will only have five years to dispose of the excess before it becomes subject to the excise tax, a grace period that is allowed to foundations that acquire excess business holdings as a result of a gift or bequest. The clock starts to tick not on the decedent's death but when the estate or trust administration has completed and the business holdings are actually transferred to the foundation. This period can be extended for an additional five years in the case of an unusually large gift or bequest of diverse business holdings with complex corporate structures if: (1) the private foundation establishes that diligent efforts were made to dispose of the excess holdings, but the holdings could not be disposed of due to size, complexity, or diversity; (2) the private foundation submits a plan for disposal of the assets within the second five-year period; and (3) the IRS approves the plan.

The excise tax rules are not the only tax consideration to the foundation continuing to own an interest in a closely held business. Even if it is determined that the foundation's holdings are not excess business holdings, the foundation may be subject to the I.R.C. §511 unrelated business income tax (UBIT) on the income earned from the business. The concept of UBIT is simple—an otherwise tax-exempt entity should have to pay tax on income from a trade or business that is unrelated to the entity's exempt purpose, just like any other taxpayer. The exempt entity must pay income tax on unrelated business income at standard corporate or trust tax rates, as applicable.

Unless a specific exception applies, income is treated as unrelated business income if the following three factors are met: (1) the income is from a trade or business; (2) the trade or business is regularly carried on; and (3) the trade or business is not substantially related to the organization's exempt purpose. The term "trade or business" generally includes any activity carried on for the production of income from the sale of goods or performance of services. Although it might otherwise fall within the definition of a trade or business, a foundation's passive income is generally not subject to UBIT.

Special attention should be paid to interests in an S corporation that a client plans to bequeath to his or her private foundation. When a foundation owns S corporation stock, the stock is automatically treated as an interest in an unrelated trade or business, and all flow-through items of income, loss, or deduction, and any gain or loss on the sale of the stock, are subject to UBIT. This is true regardless of the character of the flow-through income as passive income at the S corporation level. By holding the S corporation interest, the foundation is essentially wasting its tax-exempt status, subjecting itself to income tax it would otherwise not have to pay if it sold the S corporation stock and reinvested in other assets. Identifying this issue in the planning stage may cause a client to reconsider the bequest to the foundation, or perhaps to put in place a plan to change the business tax and corporate structure after the client's death.

A client's decision to bequeath an interest in his closely held business to his private foundation is only the first step. If the client intends for the business to continue on to the next generation, careful analysis and planning is required to determine whether the foundation can own the interest, how the foundation will divest itself of the interest, and how the foundation will be taxed if it continues to own the interest. Many of these nuances may come as a surprise to the client who thought that he was proposing a straight-forward bequest. If the issues are not addressed and planned for when the estate plan is put in place, it will fall upon the executor to come up with a solution, and, by necessity, the solution may deviate dramatically from the client's intentions.

1. Family members is defined broadly to include spouses, ancestors, children, grandchildren, great-grandchildren, and the spouses of children, grandchildren, and great-grandchildren.

2. In New York, this court proceeding is typically in the form of a Petition for Advice and Direction under §2307 of the Surrogate's Court Procedure Act. The New York State Attorney General's office is an interested party to the proceeding and must approve the terms of the proposed sale or redemption.