Minding the Shop:
Creative Planned Giving Strategies for Business Owners

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This presentation will use a case study format to help gift planners recognize unique issues and planning opportunities for business owners. The cases will analyze specific issues that arise for business owners and provide effective strategies to ensure the successful structure, implementation and administration of planned gift arrangements for these donors. This presentation will equip participants with the knowledge to identify potential gifting opportunities while also accomplishing the goals and objectives that are typical of most business owners. Specific topics include: avoiding self dealing and step transactions, dealing with buy-sell and partnership agreements, valuation of closely-held interests, etc.

TOM and JERRY FLIP-CRUT

Facts:

- Donors want to establish a charitable remainder unitrust, to be funded with highly appreciated, closely-held C corporation securities.
- Husband Donor is nearing retirement from the company and is one of three shareholders.
- Corporate shares are subject to a buy-sell agreement which gives the company a right of first refusal and contains provisions for determining the value at which an individual shareholder may transfer shares. The agreement does not contemplate a charitable gift of the shares.
- The company plans to redeem the shares at a value of $14 per share, pursuant to the terms of the buy-sell agreement.
- Donors plan to claim a deduction based upon the value of their shares as determined under the buy-sell agreement.
- Donors assure Trustee that the company will offer to redeem the shares after the trust is funded.

Issues:

- C Corporations Generally
- Redemption Process & Self Dealing
- Qualified Appraisal Rules
- Prearranged Transaction
- Unrelated Business Income

C Corporations Generally

C corporations are established under state law by the filing of articles of incorporation with the appropriate state agency. The operations of the corporation are governed by a written set of by-laws that are established by the board of directors. Members of the board of directors establish corporate policies and provide broad oversight, while the officers of the corporation lead the daily activities of the organization. The shareholders are the equity owners of the corporation, as evidenced by the issuance of shares of stock. The stock is a separate asset that may be transferred or gifted. In many closely-held corporations, shareholders enter into buy-sell agreements that limit the transfer of shares to outside parties and establish the rights of each shareholder when a transfer is contemplated. (A detailed discussion of buy-sell agreements can be found on page 6 of this outline.) As a general rule, the shareholders, directors and officers of a corporation are not legally liable for the acts and debts of the corporation.

The taxation of a C corporation is governed by Subchapter C of the Internal Revenue Code. The corporation itself is a separate taxable entity, paying tax on all income and gain incurred by the organization at corporate tax rates. Further, any distributions made to corporate shareholders will be treated as taxable income to the individual shareholder. Accordingly, it is often noted that C corporations are subject to "double taxation" – once at the corporate level and again at the individual shareholder level.

Redemption Process & Self Dealing

A charitable remainder trust which complies with IRC § 664 and for which a deduction is allowed under IRC § 170 is a "split interest trust" described in IRC § 4947(a)(2), thereby making it subject to the self dealing rules under IRC § 4941. Specifically, IRC § 4941(d)(2)(F) imposes certain restrictions regarding redemptions of closely-held stock from closely related parties. The tax regulations which speak to this issue provide that a redemption of closely-held shares held by a charitable remainder trust will not result in a self-dealing transaction so long as all the securities of the same class as that held by the trust are subject to the same terms of redemption and such terms provide for receipt by the trust of no less than fair market value. Treas. Reg. § 53.4941(d)-3(d). The regulations further state that all of the securities are not subject to the same terms unless the corporation makes a bona fide offer on a uniform basis to the trust and every other person who holds such securities. *Id.* Appendix A to this outline contains sample correspondence that may be used to properly document the redemption process to further ensure compliance with these regulations.

Qualified Appraisal Rules

In order to receive an income tax charitable deduction for their gift, the Donors must comply with certain appraisal requirements. The fair market value of the stock on the date of the gift must be determined by a "qualified appraisal" that follows all the rules set by the IRS. Treas. Reg. § 1.170A-13(c). Specifically, the qualified appraisal rules apply to gifts of property (other than money and publicly traded securities) if the value claimed or reported for the property is in excess of $5,000. Treas. Reg. § 1.170A-13(c)(1)(i). Appendix B to this outline contains a detailed summary of the qualified appraisal rules.

Note: A special rule exists for gifts of nonpublicly traded stock. If the claimed value of the stock exceeds $5,000 but is less than $10,000, the Donors will not be required to obtain a qualified appraisal. Rather, they will be required to attach a partially completed appraisal summary form (Form 8283, Section B, Parts I and II) to the tax return on which the deduction is first claimed. Treas. Reg. § 1.170A-13(c)(2)(ii).

The sole purpose of the appraisal is to allow the Donors to obtain their income tax charitable deduction, and the IRS will not allow a deduction without this appraisal. Accordingly, the Donors and their advisors bear the responsibility to obtain the qualified appraisal and to ensure that the appraisal is properly completed in a timely fashion and meets all of the requirements for qualification. While the Charity may be able to provide helpful information about the qualified appraisal rules, the final determination of the sufficiency of the appraisal rests with the Donors and their advisors.

The appraisal must be prepared no sooner than 60 days prior to the date of gift; however, the Donors are not required to have the appraisal in hand until they actually file the income tax return on which they first claim the deduction. Treas. Reg. § 1.170A-13(c)(3)(iv)(B). Nonetheless, before the trust irrevocably receives these shares of stock from the Donors, it is important to understand the interplay between the appraised value of the stock that will determine the amount of the Donors' charitable deduction and the value at which the company will redeem the shares.

If the Donors establish the trust and later obtain a qualified appraisal that places a higher value on the shares than $14 per share and subsequently claim a deduction based upon that higher value, the IRS could question the validity of the deduction amount. When claiming the deduction, the Donors must attach an appraisal summary (found in Section B of IRS Form 8283) to the income tax return on which they first claim the deduction. Treas. Reg. §1.170A-13(c)(2)(i). The appraisal summary must be signed and dated by the donee charity (or the Trustee of the charitable trust), be signed and dated by the qualified appraiser, and state the appraised fair market value of the property on the date of contribution. Treas. Reg. §1.170A-13(c)(4). Subsequently, should the Trustee sell, exchange, or otherwise dispose of any property for which the Trustee signed an appraisal summary within three years of the date of gift, the Trustee must then file an information return (IRS Form 8282) to report the amount received on the disposition. IRC § 6050L(a)(1). Should the amount claimed by the Donors as a deduction (based upon the value reported on Form 8283) significantly exceed the amount received by the Trustee on disposition of the property (as reported on Form 8282), the IRS could have grounds to question the validity of the Donors' claimed deduction.

In addition, such a discrepancy between the appraised value of the shares (and the resulting deduction) and the amount at which the shares are subsequently sold by the charitable trust could lead the IRS to determine that a self-dealing transaction occurred. As explained above, the charitable trust must receive no less than fair market value for the shares upon disposition in order to avoid a self-dealing transaction. Treas. Treas. Reg. § 53.4941(d)-3(d). Should the qualified appraisal show that the fair market value of the stock is greater than the $14 per share allowed under the buy-sell agreement, the IRS could establish that a self-dealing transaction has occurred, which could result in the imposition of sanctions under IRC § 4941.

It is also important to note that if the Donors hold less than a full ownership interest in the company, the appraised value of the Donors' stock may be discounted. Typically, an ownership interest in a business that represents less than full ownership will be discounted from 30 percent to 40 percent when appraised. This is important to remember because the charitable deduction will be calculated using this discounted appraised value while the company's calculation of the value of its stock may not reflect such a discount.

Prearranged Transaction

A prearranged transaction, formally known as a "step transaction", occurs when a series of separate and independent steps are treated as a single transaction if such steps are "in substance integrated, interdependent, and focused upon a particular result." *Esmark v. Commissioner*, 90 T.C. 171 (1988). When applied, the step transaction doctrine dictates that two or more ostensibly independent transactions (usually the gift of an appreciated asset followed by a subsequent sale of the asset by charity) be consolidated for tax purposes. This can happen when, under the facts and circumstances surrounding the gift, the donee charity is obligated to sell the gifted property to a purchaser that was prearranged by the donor prior to the gift. Hopkins, The Tax Law of Charitable Giving § 6.8 (John Wiley & Sons 1993). When this situation occurs, the IRS will view the transaction as a sale of the property by the donor to the third-party purchaser and a subsequent gift of the sales proceeds to charity, causing the donor to recognize the taxable gain from the sale of the gifted property. *Martin v. Machiz,* 251 F. Supp. 381 (D. Md. 1966).

In *Palmer v. Commissioner*, 523 F.2d 1308 (8th Cir. 1975), a taxpayer with voting control of both a corporation and a tax-exempt private foundation donated shares of the corporation's stock to the foundation and subsequently caused the corporation to redeem the shares from the foundation, pursuant to a prearranged plan. The United States Tax Court treated the transaction according to its form because the foundation was a legitimate tax-exempt entity, the transfer of stock to the foundation was a legitimate gift, and the foundation was not obligated or required to redeem the shares at the time they were received. In a subsequent revenue ruling, the Service acquiesced to the *Palmer* ruling, stating that "[t]he Service will treat the proceeds of a redemption of stock under facts similar to those in *Palmer* as income to the donor only if the donee is legally bound, or can be compelled by the corporation, to surrender the shares for redemption." Rev. Rul. 78-197, 1978-1 CB 83.

In the case at hand, the provisions of the governing buy-sell agreement gave the corporation a right of first refusal to purchase any outstanding shares from an existing shareholder. (See page 6 for a full discussion of buy-sell agreements.) However, the corporation did not have any right or authority to compel the charitable trust to surrender or sell the gifted shares. In any similar circumstance, great care must be taken to assure that any documentation which governs the transfer of shares among the donor, the donee charity (or charitable trust), and any other party must not be drafted so as to create an obligation on the part of the donee charity to sell the gifted property to a purchaser that was prearranged prior to the gift.

Unrelated Business Income

Generally, income from closely-held securities in the form of dividends or capital gain is considered "passive income" and not subject to the unrelated business income tax. IRC §§ 512(b)(1), (2), (3), and (5). However, income derived from a controlled corporation may be taxable. IRC § 512(b)(13). For this reason, it is important to be mindful of the percentage ownership that is being acquired by the Charity and the potential for earned income being realized during the length of time in which the Charity is likely to hold the controlling interest in the company.

BETTY and BARNEY RUBBLE FLIP-CRUTs

Facts:

- Donors want to make a gift to hospital using their membership interests in a limited liability company (LLC).
- Donors want to retain an income stream for their lifetimes and the lifetimes of their five children.
- Donors have been discussing succession planning for continuation of the family business, the LLC, with their attorney.

Issues:

- Limited Liability Corporations Generally
- Gifts of LLC Interests
- Documents to Review
- Membership Agreements / Business Continuation Agreements
  - A. Provisions Affecting Transfer of Ownership Interests to Charity
  - B. Provisions Affecting Post-Gift Redemption or Transfer by Charity
    1. Avoiding Step-Transactions
    2. Valuation Issues
- Succession Planning
- Redemption
- Qualified Appraisal / Valuation

Limited Liability Corporations Generally

Limited liability corporations ("LLCs") are also creatures of state law that are established with the filing of articles of organization with the proper state agency. LLCs offer the favorable tax treatment of a partnership while also providing the liability protection that shareholders in a corporation enjoy.

The equity owners of an LLC are referred to as "members" and may either conduct business based upon majority rule or by the appointment of a managing member to carry on the daily activities of the LLC. In either scenario, the members (including the managing member) retain their liability protection despite their level of involvement in the affairs of the business. Further, entities such as for-profit corporations and partnerships may participate as members of an LLC, unlike S corporations that preclude these types of entities from owning shares of S corporation stock.

Gifts of LLC Interests

While LLCs do not typically provide members with specific evidence of ownership (as do corporations with stock certificates), membership interests are nonetheless a separate asset that may be gifted or otherwise transferred. While most LLCs utilize the advantage of being taxed in the same manner as a partnership, an LLC may elect to be taxed as either a partnership or as an association taxable as a corporation. If the LLC elects to be taxed as a partnership, a charitable contribution of a membership interest will likely be treated the same as a gift of a partnership interest. (A detailed discussion of partnerships and gifts of partnership interests can be found in the last case study in this outline.) Should the LLC elect to be taxed as a corporation, a charitable contribution of a membership interest will likely to be treated the same as a gift of shares in a C corporation. (A detailed discussion of C corporations and gifts of C corporation shares can be found in the first case study in this outline.)

Documents to Review

In reviewing and analyzing the gift, the hospital will want to review the following documents:

Articles of Incorporation and any amendments

Membership /Operating Agreement and any amendments
List of membership interests
Current Valuation

Membership Agreements / Business Continuation Agreements:

More often than not, for a donor or charity contemplating a gift of closely-held securities, a membership interest in a limited liability corporation, or a partnership interest in a business, the provisions of a buy-sell agreement or business continuation agreement, typically included in the membership/operating agreement, will have to be addressed. The buy-sell agreement for a partnership is found in the partnership agreement and in the shareholder's agreement for a corporation, either C-corporation or S-corporation. Such an agreement provides for the transfer of an ownership interest in the closely-held business entity upon the occurrence of certain contemplated events. Such events typically include the owner's death, disability, insolvency, retirement, or other withdrawal from the business at an earlier time than expected. Generally, the agreement will determine the price and payment terms and, often, restrict who can own an interest in the business. Several common versions of the agreement are typically encountered, including:

1. A redemption agreement or a liquidation agreement entered into between the business itself and the individual owners whereby the business agrees to acquire each owner's interest upon the occurrence of certain stated events;

2. A cross-purchase agreement entered into among the individual owners whereby the remaining owners would acquire the withdrawing owner's interest upon the occurrence of certain stated events:

3. A "third party" business buyout agreement entered into between the individual owners and a specified individual (key person, family member, third party, etc.) whereby the withdrawing owner agrees to sell his interest to the specified individual; or

4. A combination of the foregoing.

A. Provisions Affecting Transfer of Ownership Interests to Charity

The primary reason that most buy-sell agreements and business continuation agreements are put in place is to prevent all or any part of the business from falling into the hands of outsiders. Accordingly, most of these agreements are drafted in a manner that provides the most protection possible for the business entity and its existing owners by limiting the possibility for an ownership interest to pass to any party not already associated with the business. It is rarely contemplated that a charitable gift of the closely-held business interest will occur, and as a result, you are unlikely to ever see a provision in one of these agreements that provides for a charitable contribution of an ownership interest in the business.

What you will see is a provision or multiple provisions that place restrictions on the manner in which the transfer of an existing ownership interest may be accomplished. For example, some agreements provide that an existing ownership interest may not be conveyed to any outside party without the prior approval of the board of directors or a majority of the remaining owners. In this type of situation, it is very possible to complete a gift transaction by following the procedural requirements of the buy-sell agreement or business continuation agreement to obtain the requisite approval. Typically, the members of the board of directors or the remaining owners will be closely connected to the prospective donor (family members, long-time business partners, etc.) and will understand the donor's objectives in funding a planned gift with the closely-held business interest. When open lines of communication exist between the donor and these key players within the business and these individuals have a clear understanding of the donor's intentions, it is much more probable that the donor's charitable plan will be supported and that the approval to transfer the donor's interest in the business to the donee charity will be approved. This clear

communication and understanding will also benefit the charity after the gift is completed when the charity seeks to redeem or sell the gifted interest.

More commonly, a buy-sell agreement or business continuation agreement will grant the remaining individual owners or the business entity itself, or both, a right of first refusal to acquire the ownership interest of the withdrawing owner. Only after the parties who are granted the right of first refusal under the agreement have formally declined their right to purchase may the withdrawing owner transfer his ownership interest to an outside party, such as a charity. Again, this scenario does not preclude a charitable gift of the ownership interest. In such a case, the prospective donor must take the necessary steps to provide proper notice to the relevant parties of his intention to transfer his interest, allow any required time period for the exercise of the right of first refusal to pass, and adhere to any other particulars specified under the agreement. As mentioned in the previous paragraph, clear communication and understanding of the donor's objectives in gifting the shares to charity will preclude many concerns or hesitations among the remaining owners. After all procedural steps are followed, and assuming that no one exercised the right of first refusal, the donor would be able to complete the gift of his business interest.

Finally, as a last resort, if certain provisions of the buy-sell or business continuation agreement preclude or do not allow for the transfer of an existing ownership interest to an outside party, then it may be necessary to amend the agreement before a charitable gift of the business interest may be considered. If this is deemed to be necessary, a thorough review of the document should be conducted to determine the possibility and manner in which an amendment may be made. As with other procedural aspects of the agreement, the process of amending the agreement to allow for a gift of the donor's interest to charity should be conducted carefully to ensure that the gift of the business interest to charity cannot be subsequently questioned. Once the amendment is properly made, the new provisions of the agreement should also be carefully followed to complete the gift transaction.

In this case, the provisions of the membership agreement provided that the existing members must give prior approval before any membership interest may be conveyed to an outside party. Because the other members of the LLC were all children of Donors who would ultimately receive a benefit from the CRUTs that Donors were establishing, and because the conveyance of Donors' interests to the CRUTs would increase the children's proportionate ownership interests in the LLC (following redemption), the children were very willing to approve the gift arrangement.

B. Provisions Affecting Post-Gift Redemption or Transfer by Charity

1. Avoiding Step-Transactions

After the closely-held business interest has been successfully conveyed to a charitable organization or qualified charitable trust, the charity or trustee must then consider issues which surround liquidation of the closely-held interest. As with the transfer of the interest from the donor to the charity or qualified trust, the provisions of the buy-sell or business continuation agreement can have significant consequences for the charity as a newly established owner of the business interest. Specifically, the provisions of the agreement should be closely reviewed prior to acceptance of the gifted interest in the business to ensure that a prearranged transaction (or "step-transaction") will not occur upon the subsequent disposition of the interest by the charity.

The leading case that provides guidance here is *Palmer v. Commissioner*, 523 F.2d 1308 (8th Cir. 1975), in which a redemption of gifted securities was at issue. In *Palmer*, the Court ruled that no step transaction had occurred upon redemption because the done charity was not obligated or required to redeem the shares at the time they were received. A subsequent ruling by the IRS made clear that a step transaction will only occur in this situation when, "the donee is legally bound, or can be compelled by the corporation, to surrender the shares for redemption." Rev. Rul. 78-197, 1978-1 CB 83. A more

complete discussion of the case law history and IRS rulings regarding step transactions may be found on page 4 of this outline.

Accordingly, great care must be taken to ensure that the documentation which governs the transfer of a business interest must not be drafted so as to create an obligation on the part of the donee charity to sell the gifted interest to a purchaser that is prearranged prior to the gift. It is, however, permissible for the business entity or the remaining business owners to hold a right of first refusal to purchase any outstanding business interest from a withdrawing owner. Such a right does not impose upon the donee charity an unavoidable obligation to transfer (by redemption or sale) the gifted interest to a specific party. A right of first refusal merely creates an opportunity for the holder of the right to acquire the interest should the donee charity elect to make it available.

In this case, the membership agreement did not contain any provisions whereby a member of the LLC was obligated or could be compelled to surrender his or her membership interest upon a request for redemption by the LLC. The membership agreement simply allowed the LLC to make an offer for redemption of outstanding membership interests, subject to the prior approval of the members. Because the provisions of this membership agreement were favorable, there was no concern in this case that the transaction could be regarded as a step transaction.

2. Valuation Issues

It will also be important for the donee charity to review and understand any provisions of the buy-sell or business continuation agreement that specifically determine the value of the gifted business interest for the purpose of a subsequent redemption or sale to other owners. There are several methods which are typically used to arrive at the value of a business interest. One fairly common approach is for the agreement to set the exact redemption or purchase price in advance with a further provision that would allow the parties to amend the amount in the future, as needed. Another approach is to base the purchase price upon the company's book value as determined by the most recent financial statements. A third valuation approach is to include a formula in the agreement that is to be applied at any point in time that a transfer of an interest is to be made. Formula approaches to valuation are often preferred because they allow factors such as net earnings, profitability and even goodwill to be taken into consideration.

Regardless of the method of valuation that is to be employed, the donee charity should become familiar with the manner in which valuation will be handled and determine a reasonable expectation of the benefit that actually will be received upon liquidation of the gifted interest. In this case, the membership agreement provided that a valuation formula should be used to determine the value of any membership interest that would be transferred or conveyed.

Succession Planning

Business succession planning deals with the passing of both the ownership and management of the business upon some event such as when the individual decides to sell, becomes incapacitated, decides to retire or withdraw from the business or dies and should be accomplished in light of the overall objectives of the estate plan. In this case, the donors wanted to make a charitable gift to the hospital using their membership interests in the LLC while passing ownership control of the family business to their children. The donors wanted to accomplish the transfer of ownership interest in the business in a manner that would not trigger gift tax. Therefore, the donors' membership interests were transferred to five charitable remainder trusts followed by the redemption of the interests by the LLC. By contributing their interests to the CRTs, the Donors effectively increased the percentage ownership of each of their children in the LLC without incurring gift taxes. After the redemption, the children owned 100% of the membership interests in the LLC.

Because each trust included the husband and wife and then one of the children, taxable gifts were made when the trust was created. Generally, the gifts to each spouse, even though terminable interests, would qualify for the gift tax marital deduction. IRC §2523(g)(1). However, by adding the children as successor beneficiaries, the marital deduction is lost. IRC §2511. The loss of the marital deduction at the death of the first spouse resulting from adding each child as a successor beneficiary was taken into consideration in the planning stage. IRC §2511. The Donors retained the right, exercisable only by will, to revoke the gift of the income interest to the children at the death of the surviving Donor in the trust document, thereby delaying, until the death of the surviving Donor, the gift tax implications to the children. If the right to revoke is exercisable during the Donors' lifetimes, the CRT is disqualified. Treas. Reg. §§ 1.664-2(a)(4), 1.664-3(a)(4), 1.6642(c)-5(b)(2).

Redemption

In order to achieve Donors' objective of increasing the respective ownership interests of the children in the LLC and to provide liquidity to the CRUTs which will allow income distributions to begin, the LLC will redeem the ownership interests held in each of the CRUTs. Pages 3and 4 of this outline contains a detailed discussion about the redemption of closely-held business interests from qualified charitable trusts or private foundations and explains the interplay between the valuation of closely-held business interests as part of the redemption process and the potential that exists to create a self-dealing transaction under Treas. Reg. § 53.4941(d)-3(d). In this situation, the donor should be advised to carefully consider the applicable regulations and Code sections (identified on pages 3 and 4 of this outline) to ensure that a self-dealing transaction does not occur upon redemption of the gifted business interest from the qualified charitable trust.

Qualified Appraisal / Valuation

As discussed in the prior case, the Donors must comply with certain appraisal requirements in order to receive an income tax charitable deduction for his gift. The fair market value of the contributed membership interests must be determined by a "qualified appraisal" that follows all the rules set by the IRS. Treas. Reg. § 1.170A-13(c). Page 3 of this outline contains a detailed discussion of the qualified appraisal rules that apply to closely-held business interests, and Appendix B to this outline contains a detailed summary of the qualified appraisal rules also.

Conclusion

In addition to passing ownership in the LLC to family, the Donors diversified their holdings and created additional retirement income, reduced their taxable estates, received an immediate charitable income tax deduction and left a legacy to their charity.

FOGHORN LEGHORN FLIP-CRUT

Facts:

- Donor owns 47% of the outstanding shares of a closely-held S corporation, and he serves as chairman of the company's board of directors.
- Donor's ownership interest is valued at approximately $4 million.
- The board of directors is currently considering an offer to sell the company to a larger competitor.
- The shareholders of the company will meet in three weeks. A vote to approve the sale is expected to occur at that meeting.
- Donor's shares are highly appreciated, and he wants very much to avoid the capital gains tax that would result from the sale.
- Donor wishes to place the shares into a charitable remainder unitrust to benefit several charitable organizations.

Issues:

- S Corporations Generally

- Gifts of S Corporation Stock
- Anticipatory Assignment of Income
- Qualified Appraisal

S Corporations Generally

Like C corporations, S corporations are also established under state law by the filing of articles of incorporation with the proper state agency. Also similar, the by-laws adopted by the board of directors provide a structure for the governance of the corporation. The roles of board members, officers and shareholders are also the same as with a C corporation. And, directors, officers and shareholders are generally not liable for the debts and acts of the corporate entity.

Prior to 1998, charitable organizations were not included as eligible shareholders of S corporations. If S corporation shares were transferred to a charity, the corporation would immediately lose its S corporation status and become taxed the same as a C corporation. However, the Small Business Job Protection Act of 1996 (P.L. 104-188) allowed charitable organizations to be included among the eligible shareholders of S corporations as of January 1, 1998. Other eligible shareholders include individuals, estates, and certain trusts (discussed below). Partnerships and for-profit corporations are not allowed as shareholders of S corporations. Nonetheless, the passage of the Small Business Job Protection Act created new opportunities for donors and charities by allowing gifts of stock in many closely-held companies that were previously not possible.

The taxation of S corporations is governed under Subchapter S of the Internal Revenue Code and is notably different from the taxation of C corporations. The foremost difference is that the S corporation is not treated as a separate taxable entity. Rather, all taxable gain and income passes through to the individual shareholders. For this reason, the S corporation is often referred to as a "pass through" entity.

Gifts of S Corporation Stock

For a contribution of S corporation stock that qualifies as long-term capital gain property, the donor would be allowed a charitable contribution deduction for the fair market value of the stock, and the donor would not be taxed on any capital gain in the stock. However, this deduction amount must be reduced by the amount of gain that would have been ordinary income had the donor sold the S stock himself. IRC § 170(e). In other words, the donor of S corporation shares may only deduct the amount of his tax basis in the shares.

Also, once received by the charitable donee, gifted shares of S corporation stock will be treated as an interest in an unrelated trade or business. As such, all items of income or loss will be considered as unrelated business income that is taxable to the charity even if the underlying business activity is a passive one. IRC § 512(e). Also, any gain or loss on the disposition of the S corporation shares by the charity will also be taxable as unrelated business income. *Id*.

A transfer of shares of S corporation stock to a charitable remainder trust will cause the corporation to immediately lose the S election for all shares, not just for those shares actually contributed to the trust. IRC § 1361(e)(1)(B)(iii). In most cases, the resulting negative tax consequence for all other shareholders will preclude a donor from gifting S stock into a CRUT. However, because all of the company shares in this situation will soon be sold, this otherwise undesirable result may be of little consequence to the other shareholders.

It is also important for the Donor to be aware that, if the S corporation has operated as a C corporation at any time during the previous ten years, the corporation could have some retained earnings that would be taxed as ordinary income upon the conversion of the corporation by the loss of the S election.

Anticipatory Assignment of Income

Because the sale of the company is drawing near, care must be taken to assure that an anticipatory assignment of income does not occur upon the transfer of the Donor's shares to the trust. The oft quoted statement regarding the assignment of income doctrine made by Justice Oliver Wendell Holmes states that an "arrangement by which the fruits are attributed to a different tree from that which they grew" is not recognized for income tax purposes. *Lucas v. Earl, Guy* (1930, S. Ct.) 8 AFTR 10287, 281 US 11, 74 (Ed 73), 2 USTC. When an anticipatory assignment of income does occur, the gain from the sale of the stock is taxable to the donor on the theory that the asset transferred

to the charitable trust by the donor was, in practical effect, a right to receive cash rather than an asset that might or might not be converted to cash at some time in the future.

However, a "mere anticipation or expectation of the receipt of income" is insufficient to conclude that a fixed right to income exists. *S.C. Johnson & Son, Inc. v. Commissioner*, 63 T.C. 778, 787-88 (1975). In the situation where the transfer to the charitable trust is made before the shareholder vote to liquidate, the gain will be taxed to the charitable trust, not the donor, but because the remainder trust is a tax exempt entity, no recognition of gain will occur. *Stern v. Commissioner*, 15 T.C. 521 (1950). So, time is of the essence.

Whether the assignment of income doctrine and/or the step transaction doctrine apply are fact sensitive questions. Several key cases provide guidance:

> *Palmer v. Commissioner* 523 F2d 1308 (see discussion in Tom & Jerry case above);
> *Blake v. Commissioner* 83-1 (USTC Para 9121 (2d Cir. 1983));
> *Ferguson v. Commissioner* (174 F3d 997 (9th Cir. 1999)); and,
> *Rauenhorst v. Commissioner* (119 T.C. No. 9 (Oct. 2002)).

Since in this case the stock is closely-held, we look at *Rauenhorst* and compare the facts based upon the discussion in the case. If Rev. Rul. 78-197 is applicable, then the test is whether the donee can be compelled, or legally bound, to surrender the shares. If Rev. Rul. 78-197 does not apply, then the standard discussed in *Ferguson* should be applied: "Although control over the disposition of the transferred property is significant to the assignment of income analysis, the ultimate question is whether the transferor, considering the reality and substance of all the circumstances, had a fixed right to income in the property at the time of transfer."

Note: In all relevant cases on this point, the Service did not assert that the donation itself was defective or that the charitable deduction should be disallowed. The issue was always the exclusion of capital gain arising from the donated asset.

Qualified Appraisal

As discussed in the prior cases, the Donor must comply with certain appraisal requirements in order to receive an income tax charitable deduction for his gift. The fair market value of the stock on the date of the gift must be determined by a "qualified appraisal" that follows all the rules set by the IRS. Treas. Reg. § 1.170A-13(c). Page 3 of this outline contains a detailed discussion of the qualified appraisal rules that apply to closely-held business interests, and Appendix B to this outline contains a detailed summary of the qualified appraisal rules also.

GEORGE and JANE JETSON GIFT ANNUITY

Facts:

- Husband and Wife ("Donors") each own a 50% partnership interest in a family limited partnership ("FLP") that owns and manages multiple duplex units near the campus of a major university ("University").
- University is seeking to acquire neighboring tracts of land to provide for much needed expansion of campus facilities.
- University has approached Donors with an offer to purchase one of the duplex units from the FLP at a price of $2,500,000 – well above what the market would otherwise support.
- The FLP's basis in the duplex is $300,000.
- Donors have a history of philanthropy and want to benefit a charitable organization ("Charity" – a different institution from University referred to above) through this transaction in the most tax efficient manner possible.
- After considering multiple options and upon the advice of counsel, Donors elect to convey a 40% undivided interest in the duplex from the FLP to Charity (not to University) in exchange for a gift annuity that names Donors as life annuitants.

Issues:

- Overview of Partnership Entities
  - A. General Partnership
  - B. Limited Partnership
  - C. Family Limited Partnership
  - D. Limited Liability Partnership
- Gifts made by Partnership Entities
  - A. General Tax Treatment
  - B. Adjustment of Partners' Bases
  - C. Limitation on Deduction
  - D. Distribution Followed by Transfer
- Partial Interest Rule
- Unrelated Business Taxable Income
- 10% Rule Concerns

Overview of Partnership Entities

A partnership is a business entity in which two or more persons join together in furtherance of a joint purpose. Participants in the partnership typically share in the expenses and profits of the venture in a pro-rata manner, according to their respective ownership interests in the partnership. While a partner's ownership interest in a partnership is not typically evidenced in the manner that a corporate ownership interest would be (*i.e.*, a stock certificate), the partnership interest is nonetheless an identifiable separate asset which can be valued and transferred. Generally, there are four types of partnerships:

A. **General Partnership** – Under a general partnership arrangement, each partner is legally liable for the debts and actions of the partnership. No formal agreement is necessary to establish a general partnership, and no type of documentation is required to be filed with any state agency.

B. **Limited Partnership** – A limited partnership has two types of partners – general partners and limited partners. The general partner will be responsible for the management and operations of the partnership and will also be held personally liable for the debts and actions of the partnership. By contrast, the limited partner will have little involvement in the operations of the partnership and will not typically be held legally liable for the debts and actions of the partnership. Care must be taken by limited partners to limit their involvement in the activities of the partnership so as to preserve their limited liability status. Finally, a limited partnership must be formally established by filing a certificate of limited partnership with the appropriate state agency.

C. **Family Limited Partnership** – A family limited partnership, as its name implies, is simply a limited partnership in which all of the partnership interests are held by family members. This form of partnership combines the favorable tax treatment provided for family partnerships under IRC Sec. 704(e) along with the advantages of a limited partnership under the Uniform Limited Partnership Act (ULPA).

D. **Limited Liability Partnership** – The primary distinctive feature of the limited liability partnership is that none of the partners are usually legally liable for the debts and actions of the partnership, and a non-partner is retained to manage the affairs of the partnership.

Gifts made by Partnership Entities

A. **General Tax Treatment** – Like S corporations and limited liability companies, partnership entities are commonly referred to as "pass-through" entities because tax is generally not imposed at the entity level. Unless the entity specifically elects to be taxed as a corporation, the partnership entity will be taxed as a partnership under Subchapter K of the Internal Revenue Code. Reg. §

301.7701-2(a). As such, all tax attributes, including income, loss, gains, credits, and charitable contributions, will "pass through" to the individual partners and be reported by them in proportion to their ownership interests. IRC § 1363(a) and IRC § 701. The amount of the charitable deduction resulting from a contribution made by a partnership entity will be determined at the entity level based upon the nature of the property given and the type of charity that receives it. The ability of each partner to claim their proportionate share of the deduction amount will be determined by the individual partner's adjusted gross income and deduction phase-outs. IRC § 702(a)(4).

B. **Adjustment of Partners' Bases** – Before the decision is made to make a charitable contribution by the partnership entity, consideration should be given to the impact that the contribution will have on each partner's basis in his or her partnership interest. Specifically, the IRS has ruled that when a partnership makes a charitable contribution of property, the basis of each partner's interest in the partnership is decreased (but not below zero) by the partner's respective share of the partnership's basis in the property contributed. Rev. Rul. 96-11, 1996-1 CB 140. Ultimately, the consequences of this basis reduction would likely be an increase in gains tax on a subsequent sale or cash liquidation of the partnership interest or the disallowance of future partnership losses. In the case at hand, the contributed property had a relatively low basis compared to the total basis of each partner in the partnership entity. As a result, the Donors were not dissuaded from making the gift through the FLP entity, because the impact on each partner's total basis in the FLP was not significantly reduced.

C. **Limitation on Deduction** – While an individual owner's basis in another type of pass-through entity (*i.e.*, S corporations or limited liability companies) may limit their ability to claim their proportionate share of a charitable deduction resulting from a gift made by the entity, partners in a partnership do not normally have this constraint. One nationally recognized treatise has noted that the relevant statute (IRC § 704(d)) and its underlying regulations do not include charitable contributions among the list of items subject to limitation for partners in a partnership based upon their individual bases and speculates that this omission may be a "technical flaw". McKee, Nelson & Whitmire, Federal Taxation of Partnerships and Partners ¶ 10.05[1][b] (Warren, Gorham & Lamont, 3d ed.). In one private letter ruling involving a contribution of land by a partnership entity to a public charity, the IRS noted that IRC § 704(d) does not specifically refer to charitable contributions and, therefore, does not impose a limit on the individual partner's ability to claim his proportionate share of the contribution deduction. Priv. Ltr. Rul. 8405084.

D. **Distribution Followed by Transfer –** An alternate approach to completing the gift would be to have the partnership entity make a partial or complete distribution of partnership assets to the partner, followed by a gift of the distributed property from the partner in his or her individual capacity.

Generally, a distributee partner will only realize gain to the extent that he receives money or marketable securities in an amount that exceeds his basis in the partnership entity. IRC § 731(a)(1) and IRC § 731(c). When a distributee partner receives a distribution of property other than money or marketable securities, he will not generally recognize any gain until he sells or otherwise disposes of the property. The only exception to this rule involves less common scenarios outlined in IRC §736 (relating to payments of a retiring partner or a deceased partner's successor in interest) and IRC §751 (relating to unrealized receivables and inventory items). Reg. § 1.731-1(a)(1). Therefore, it is possible under certain circumstances, for a partner to forego recognition of gain upon receiving a distribution of property from a partnership followed by the subsequent transfer of the distributed property to a charitable organization.

It should also be noted that a distribution of property (which includes money and marketable securities) by a partnership to a partner does not result in recognized gain or loss to the partnership under IRC § 731. However, the partnership may have to recognize gain or loss on certain distributions under IRC § 751(b) where the distribution must be treated as a sale or exchange of property between the partner and the partnership. Reg. § 1.731-1(b).

In this case, the Donors would have been able to receive the distribution of real property from the partnership without recognition of any gain. Nonetheless, the rules governing the treatment of long-term capital gain from assets gifted in exchange for a qualified charitable gift annuity would still apply.

Partial Interest Rule

As a general rule, income, gift and estate tax law limits a donor's ability to claim a deduction for a contribution of less than the donor's entire interest in the property contributed. IRC § 170(f)(3)(A), Reg. § 1.170A-7(a)(1); IRC § 2522(c)(2), Reg. § 25.2522(c)-3(c)(1)(i); and IRC § 2055(e)(2), Reg. § 20.2055(c)-2(e)(1)(i). Notwithstanding this general rule, certain exceptions to the "partial interest rule" are also outlined in tax law and serve to create the giving opportunities for the majority of planned giving donors. The most familiar exception allows a contribution deduction for gifts of less than a donor's entire interest in property which are made in trust. IRC § 170(f)(3)(A). The other primary exceptions include the following:

- A remainder interest in a personal residence or farm. IRC §§ 170(f)(3)(b)(i), 2522(c)(2), and 2055(e)(2);
- Qualified conservation contributions. IRC §§ 170(f)(3)(b)(iii), 2522(c)(2), 2522(d), 2055(e)(2), and 2055(f). See also IRC § 2031(c) for estate tax exclusion;
- Works of art separated from their copyright (gift and estate tax deduction only). IRC §§ 2522(c)(3), and 2055(e)(4); and
- An undivided portion of a taxpayer's entire interest in property. IRC §§ 170(f)(3)(B)(ii), 2522(c)(2), and 2055(e)(2).

In this case, the Donors elected to convey a 40% undivided interest in one of their duplexes. This percentage was chosen so that Charity would receive $1,000,000 (40% x $2,500,000 sales price) from the subsequent sale of the duplex to University. As noted above, such a contribution of an undivided portion of a taxpayer's entire interest in property is deductible so long as the gift is not made in trust. Reg. § 1.170A-7(b)(1)(i). Because the donors elected to make this gift in exchange for a qualified charitable gift annuity, the bargain sale rules applied, and the deduction was allowable. In this situation, the applicable regulations require that the undivided portion of the donor's entire interest in the property must:

- consist of a fraction or percentage of each and every substantial interest or right owned by the donor in the property, and
- extend over the entire term of the donor's interest in the property and in other property into which the property may be converted. *Id*.

By conveying an undivided 40% interest to Charity from its previous 100% ownership interest in the duplex, the FLP was in compliance with the governing Code provisions and regulations regarding the partial interest rule.

Unrelated Business Taxable Income

Unrelated business taxable income ("UBTI") includes "the gross income derived by any organization from any unrelated trade or business ….regularly carried on by it…." IRC § 512(a)(1). The term "unrelated trade or business" means, in the case of any organization subject to tax imposed by IRC § 511, any trade or business the conduct of which is not substantially related to the exercise or performance by such organization of its charitable, educational or other purpose or function. IRC § 513(a). Tax-exempt organizations are subject to tax on their UBTI at the regular corporate tax rates. IRC § 511. Excessive UBTI for a tax-exempt organization can ultimately jeopardize its tax-exempt status.

However, the Code also identifies certain unrelated business activities that, when conducted by a tax-exempt organization, are excluded from UBTI. Such excluded income is often referred to as "passive income". One such exclusion is provided under the Code for certain types of rents, and specifically for rents from real property. IRC § 512(b)(3)(a)(i).

Nonetheless, not all income referred to as "rent" will qualify for the exclusion. The applicable tax regulation notes that the rendering of certain types of services to the lessee will impact whether or not the exclusion will apply. Specifically, when services are rendered to an occupant primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only, then the exclusion will not apply and the income derived from the lease arrangement will be treated as UBTI. Reg. § 1.512(b)-1(c)(5). For example, providing maid service to an occupant would be a service provided for the convenience of the occupant and would not be typically provided for occupants of private residences, duplexes, other multi-family housing units, office buildings, etc. *Id*. However, other services such as the furnishing of heat and light, the cleaning of public areas (including entrances, exits, stairways and lobbies), and the collection of trash would not be the types of services that would prevent the exclusion from applying. *Id*.

In addition, rental income may also be treated as UBTI when the amount of the rent paid to the tax-exempt lessor is based upon the net income of the lessee. Specifically, the "passive rent test" stipulates that where the determination of the amount of rent depends in whole or in part on the income or profits derived by any person from the property leased, then the exclusion shall not apply, and the rent income will be treated as UBTI. Reg. § 1.512(b)-1(c)(2)(iii)(b). This rule precludes avoidance of unrelated business income tax by tax-exempt lessors who are involved in a profit sharing arrangement and are therefore an active participant in the operation of the property. Hopkins, The Law of Tax-Exempt Organizations § 24.6(h) (John Wiley & Sons, 9th ed. 2007). However, the applicable regulation makes it clear that the exclusion will apply in any situation where the rent is based upon a fixed percentage or percentages of the gross receipts or sales of the lessee. Reg. § 1.512(b)-1(c)(2)(iii)(b).

The recipient Charity in this case was free from any concern about UBTI from the duplex. First, the applicable regulation cited above also states that payments for the use or occupancy of entire private residences, or living quarters in duplex or multiple housing units, or offices in any office building, etc., are generally treated as rent from real property. Reg. § 1.512(b)-1(c)(5). In addition, Donors had not historically provided any non-typical services to the tenants of the duplex and the rental amount was based upon an agreed flat rate. For these reasons, Charity was comfortable that UBTI would not be realized from its ownership of the duplex unit after the gift was completed.

10% Rule Concerns

In this case, the Donors chose to gift the duplex to Charity (not the same institution as University) in exchange for a qualified charitable gift annuity. Because of the burden of having to make immediate annuity payments to donors under an immediate gift annuity obligation, many charities have gift acceptance policies that preclude receiving illiquid assets, such as real property, in exchange for a gift annuity. Charity was willing in this case to issue the gift annuity in exchange for the interest in the duplex because of the great probability that University would purchase the property soon after the date of gift.

In reviewing documentation related to the gift arrangement, counsel for the Donors reviewed the gift annuity agreement and related information provided by Charity and all documentation related to the conveyance of the duplex. Specifically, Donors' counsel reviewed a proposed contract for sale of Donors' retained 60% undivided interest in the duplex to University, which would occur only after the gift arrangement was completed. Because University was involved in numerous real estate negotiations for properties near the duplex and adjacent to the campus, the proposed contract (which was prepared by University's general counsel) contained a confidentiality provision which prohibited Donors from later disclosing the sales price to any outside party. It was later realized that all neighboring properties near the duplex were acquired by University with the same type of confidentiality provision. In reviewing the proposed contract for sale, Donors' counsel failed to realize the impact that the confidentiality provision would have on the Donors' subsequent effort to obtain a qualified appraisal.

After the gift was completed, Donors and Charity both sold their respective undivided interests to University, subject to the confidentiality provision described above. In the weeks that followed, Donors realized that they would be unable to obtain a qualified appraisal for the duplex that would approximate the total sales price of $2,500,000 that was paid by University to Donors (60%) and Charity (40%) for their respective undivided interests. Because the sales amounts for all comparable properties in the area (limited to those zoned as multi-family) were unavailable to any third-party appraiser because of the confidentiality provisions, the Donors soon realized that they would only be able to obtain an appraisal placing a total value of approximately $1, 200,000 on the duplex.

Charitable organizations could jeopardize their tax-exempt status by issuing annuity contracts that constitute "commercial-type insurance". IRC § 501(m)(1). However, the definition of "commercial-type insurance", as it relates to this section of the Code, specifically excludes charitable gift annuities. IRC § 501(m)(3)(E). To qualify as a charitable gift annuity, the arrangement must meet the requirements of IRC § 514(c)(5). Among those requirements is the stipulation that the present value of the annuity must be less than 90 percent of the value of the property received in the exchange. IRC § 514(c)(5)(A). Said differently, the present value of the charitable benefit must equal at least 10 percent of the value of the property given in exchange for the gift annuity.

In this case, it was soon realized that the Donors' inability to establish a fair market value for the gifted property that approximated the amount of the proceeds actually received on the subsequent sale created a "10% rule" dilemma. Charity issued the gift annuity at the recommended ACGA rate or 6% for joint donors aged 71 and 73 (based upon rates in effect as of the date of gift in 2007), but Charity based this annuity payout rate on the anticipated amount of sales proceeds that would ultimately be received from University. Because all comparable real estate sales were unavailable to appraisers due to University's confidentiality provisions, the amount of the annuity payments appeared disproportionately high (well above what the recommended rate would be) compared to the value that could be shown by a qualified appraisal.

As a result, this gift annuity arrangement failed to qualify under the applicable provisions of the Code. IRC § 514(c)(5). After consulting with several advisors over a period of weeks, Donors ultimately concluded that they would need to "step" the transaction. Accordingly, the Donors elected to treat the transaction, for tax reporting purposes, as if they had sold the entire 100% interest in the duplex to University for $2,500,000 and subsequently gifted $1,000,000 cash to Charity in exchange for the gift annuity. While Donors were disappointed to pay the gains tax that resulted, they were benefitted from the greatest possible deduction amount resulting from the "cash gift", the ability to claim the deduction at 50% of their adjusted gross income (compared to the 30% limitation allowed for appreciated property gifts) and a significantly higher amount of tax-free income received through the annuity payments for the duration of their lifetimes.

From Charity's perspective, the issuance of a gift annuity that failed to meet the requirements of IRC § 514 (c)(5) will cause the annuity obligation to be treated as acquisition indebtedness, resulting in possible unrelated business taxable income for Charity. Frank Minton, Charitable Gift Annuities – The Complete Resource Manual 2.10 (2007).

The moral of this story: proceed with caution when funding charitable gift annuities with illiquid assets whose value may be difficult to determine. In this case, Donors would have been well advised to obtain a qualified appraisal before finalizing the gift. If they had done so, the issue with the 10% rule would have become a red-flag and would have allowed the Donors to weigh their options and make a determination of the best way to complete the gift and obtain the greatest tax benefit.

Appendix A

Sample Letters Documenting Redemption of Closely-Held Securities from a Qualified Charitable Trust or Private Foundation

[CLOSELY-HELD CORPORATION, INC. STATIONARY]

_____

_____

[THIS IS A DRAFT OF AN OFFER LETTER TO SEND
TO ALL CLASS A STOCK SHAREHOLDERS]

_____, 2008

Mr. Joseph E. Hancock
Trust Counsel
Baptist Foundation of Texas
1601 Elm Street, Suite 1700
Dallas, Texas 75201-7241

Dear Mr. Smith:

As you are aware, Baptist Foundation of Texas currently owns 12,400 shares of Closely-Held Corporation, Inc. Class A stock as Trustee of the ____________________ *Charitable Remainder Unitrust No. 1*.

This letter is to inform Baptist Foundation of Texas that a redemption of Closely-Held Corporation, Inc. Class A stock will be open from _____, 2008, until _____, 2008, during which time the corporation will purchase from the shareholders any or all Class A shares held by them for $_____ per share. All purchases will be made in cash. The valuation of the Closely-Held Corporation, Inc. Class A stock was made on _____, 2008, and it was this valuation which was used to determine the purchase price stated above.

You may redeem your Class A shares at fair market value until _____, 2008.

Sincerely,

____
President
Closely-Held Corporation, Inc.

[THIS IS A DRAFT LETTER THAT THE CHARITY MAY SEND TO THE CLOSELY-HELD CORPORATION IN RESPONSE TO THE REDEMPTION OFFER.]

_____, 2008

Mr. ___________________
President
Closely-Held Corporation, Inc.
____
____

Dear Mr. ____________________:

We have received your offer to redeem the 12,400 shares of the Class A stock of Closely-Held Corporation, Inc. held by a charitable remainder unitrust established by Mr. and Mrs. ____________________, of which Baptist Foundation of Texas is Trustee.

As you may know, charitable remainder trusts are subject to certain self-dealing rules under the Internal Revenue Code that impose restrictions regarding redemptions of stock from closely related parties. Those restrictions allow for a redemption of the trust's shares, so long as the offer price is at fair market value and so long as the same offering is made on the same basis to all other holders of the same class of stock which is the subject of the redemption.

Baptist Foundation of Texas, acting as Trustee of the referenced trust, is prepared to accept the offer of redemption of all of its 12,400 shares at $_____ per share, for a total price of $_____.

We request that you verify the accuracy of the information above to confirm that a self-dealing transaction does not occur. Upon verification of that information, we would request that you provide a check payable to Baptist Foundation of Texas in the amount of $_____. If there is any variance from the assumptions stated above that would cause this transaction to be treated as an act of self-dealing, please advise us of what assumptions are incorrect prior to mailing the check.

Thank you very much for your help with this matter. If I can provide anything further, please let me know.

Sincerely,

Joseph E. Hancock
Trust Counsel
Direct Dial: 214-978-3394
Direct Fax: 214-978-3395

[CLOSELY-HELD CORPORATION, INC. STATIONARY]

_____

_____

[VERIFICATION LETTER TO BE SENT TO THE CHARITY FROM THE CLOSELY-HELD CORPORATION]

_____, 2008

Mr. Joseph E. Hancock
Trust Counsel
Baptist Foundation of Texas
1601 Elm Street, Suite 1700
Dallas, Texas 75201-7241

Dear Joe:

On _____, 2008, a valuation of Closely-Held Corporation, Inc. Class A stock was made and, as of that date, the fair market value per share of Closely-Held Corporation, Inc. Class A stock was determined to be $_____. All Class A stockholders of Closely-Held Corporation, Inc. were informed in writing on _____, 2008, that a redemption of Closely-Held Corporation, Inc. Class A stock would be open from that date until _____, 2008, during which time the corporation would purchase from the shareholders any or all Class A shares held by them for $_____ per share. All purchases would be made in cash.

Accordingly, the offer to redeem shares held by the charitable remainder trust created by Mr. and Mrs. ____________________ on December _____, 2008, with Baptist Foundation of Texas, as Trustee, was made on the same terms as the offer made to all other Class A shareholders, and the offer was made at fair market value. The offer to Baptist Foundation of Texas, as Trustee of the ____________________ *Charitable Remainder Unitrust No 1, w*as made on _____, 2008, and the redemption occurred on _____ 2008, which was in the redemption period referenced above.

Sincerely,

____
President
Closely-Held Corporation, Inc.

Appendix B

Qualified Appraisal Requirements

Qualified Appraisal Requirements

[These steps must be followed by a “qualified appraiser” to meet the criteria established by the Internal Revenue Service for non-cash charitable gifts.]

1. The appraisal must be prepared no earlier than 60 days prior to the date that the contribution is made, and must be prepared not later than the due date of the return on which the deduction is claimed or the date an amended return is filed if the amended return is the first return on which the deduction is claimed.

2. The appraisal must be prepared, signed and dated by a qualified appraiser as defined below.

3. The appraisal must include the following information:

   a. A description of the property in sufficient detail for a person who is not generally familiar with the type of property to ascertain that the property that was appraised is the property that was (or will be) contributed;

   b. In the case of tangible property, the physical condition of the property;

   c. The date (or expected date) of contribution to the donee;

   d. The terms of any agreement or understanding entered into (or expected to be entered into) by or on behalf of the donor which relates to the use, sale or other disposition of the property contributed. This includes restrictions on the donee’s right to use or dispose of the donated property, all provisions which confer on anyone, other than the donee charity, the right to income from the donated property or the right to possession of the property, including voting rights to securities, a right of purchase, or a right to designate the person to receive income, possession or right of purchase, or a provision which earmarks the donated property for a particular use. As an added precaution, all agreements between the donor and the donee charity relating to the gift should be attached to the appraisal and incorporated into it by reference;

e. The name, address, and taxpayer identification number of the qualified appraiser and, if the qualified appraiser is a partner in a partnership, an employee of any person (whether an individual, corporation, or partnership), or an independent contractor engaged by a person other than the donor, the name, address and taxpayer identification number of the partnership or the person who employs or engages the qualified appraiser;

f. The qualifications of the qualified appraiser;

g. A statement that the appraisal was prepared for income tax purposes;

h. The date or dates on which the property was valued;

i. The appraised fair market value of the property on the date (or expected date) of contribution;

j. The method of valuation used to determine the fair market value, such as the income approach, the market data approach, or the replacement-cost-less-depreciation approach;

k. The specific basis for the valuation, if any, such as any specific comparable sales transactions;

l. A description of the fee arrangement between the donor and the appraiser.

4. The appraiser must sign the appraisal summary upon its presentation to the appraiser by the donor. In this regard, no part of the fee arrangement for a qualified appraisal can be based, in effect, on a percentage (or set of percentages) of the appraised value of the property.

5. To be a "qualified appraiser," the appraiser must sign and complete Internal Revenue Service Form 8283, Section B, denoted "Appraisal Summary." The Appraisal Summary includes declarations by the appraiser that:

   a. The individual holds himself or herself out to the public as an appraiser;

   b. Because of the appraiser's qualifications as described in the appraisal, the appraiser is qualified to make appraisals of the type of property being valued.

   c. The appraiser is not:

      (1) The donor or the taxpayer who claims or reports the deduction under Section 170 for the contribution of the property being appraised;

(2) A party to the transaction in which the donor acquired the property being appraised (i.e., the person who sold, exchanged or gave the property to the donor, or any person who acted as an agent for the transferor or for the donor with respect to such sale, exchange or gift), unless the property is donated within two months of the date of acquisition and its appraised value does not exceed its acquisition price;

(3) The donee of the property;

(4) Any person employed by any of the foregoing persons or related to any of the foregoing persons under Section 267(b) (e.g. if the donor acquired a painting from an art dealer, neither the art dealer nor persons employed by the dealer can be qualified appraisers with respect to that painting);

(5) Any person whose relationship with any of the persons listed in (1) through (4) above would cause a reasonable person to question the independence of such appraiser. For example, an appraiser who is regularly used by any person described in (1) through (3) above and who does not perform a substantial number of appraisals for other persons has a relationship with such person that is similar to that of an employee and cannot be a qualified appraiser with respect to the property contributed.

d. The appraiser understands that a false or fraudulent overstatement of the value of the property described in the qualified appraisal or appraisal summary may subject the appraiser to a civil penalty under Section 6701 for aiding and abetting an understatement of tax liability, and consequently the appraiser may have appraisals disregarded pursuant to 31 U.S.C. Section 330(c).

Baptist Foundation of Texas
Addendum to Qualified Appraisal Requirements

The Pension Protection Act of 2006 made some changes to the rules concerning qualified appraisals, including the creation of statutory definitions of the terms "qualified appraiser" and "qualified appraisal." Those definitions will be clarified in regulations to be issued by the U.S. Treasury Department. In the interim period, the Internal Revenue Service has issued transitional guidance to be followed until the new regulations take effect.

In order to comply with the IRS's interim rules, an appraisal must include, in addition to the requirements listed above in Qualified Appraisal Requirements, the following items:

- A statement that the appraiser regularly performs appraisals for which he receives compensation;
- A declaration that, because of his background, experience, education, and membership in professional associations, the appraiser is qualified to make appraisals of the type of property being valued;
- A declaration that the appraiser has not been prohibited from practicing before the IRS by the Secretary under Section 330(c) of Title 31 of the United States Code at any time during the three-year period ending on the date of the appraisal;
- A statement that the appraiser conducted the appraisal in accordance with generally accepted appraisal standards; and

Either:

- (for real property) a copy of the appraiser's license or certification for the type of property being appraised in the state in which the appraised real property is located; or
- (for other types of property) a full description of the education and experience that qualify the appraiser to value the type of property being valued. In this regard, the appraiser must have successfully completed college or professional-level coursework that is relevant to the property being valued, and have obtained at least two years of experience in the trade or business of buying, selling, or valuing the type of property being valued.

In addition, the appraiser should note that IRS Form 8283 (referred to in paragraph 5 of Qualified Appraisal Requirements) has been amended to include an additional declaration clarifying:

> That he understands that a substantial or gross valuation misstatement resulting from the appraisal of the value of the property that he knows, or reasonably should know, would be used in connection with a return or claim for refund, may subject him to the penalty under Section 6695A.