

Gifts of LLC Interest

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What is an LLC interest?

LLC is an abbreviation for limited liability company and it is a form of business entity allowed under individual state statutes. Other common forms of business entities include the following: sole proprietorship, general and limited partnership, C corporation, S corporation and a limited liability partnership. Each type of business entity offers different levels of personal liability protection and tax benefits. Generally business owners select the appropriate form of business entity based on their desired level of personal liability protection and the tax benefits. Owners of LLCs are referred to as members while owners of corporations are shareholders and owners of partnerships are called partners.

LLCs, C corporations, S corporations and limited partnership all provide limited liability to the owners. Thus, the owners are not personally liable for business activities or debts. Such owners, however, can be liable for business debts if they agree to assume such liability generally at the request of the lender. Further, if the business engages in fraud, does not operate properly as a business such as hold regular board meetings with recorded minutes or engages in misrepresentation, the limited liability shield may be pierced and the owners subject to personal liability. Owners of general partnerships, sole proprietorships and majority owners of limited liability partnerships are personally liable for business operations and debts and as such are often avoided for holding real estate.

The downside to C corporations is the two layers of tax. Corporate net income is subject to tax at the corporate level and when corporate profits are distributed to shareholders, the shareholders pay taxes on the dividends. Essentially the same profits are taxed twice. Partnerships and S corporations do not pay a tax at the business or entity level. Rather, the income or losses of the business flow through to the owners who report such income or losses on their personal income tax returns. A sole proprietor simply reports his or her business activity on schedule C of his or her personal income tax return.

Before the creation of LLCs, under state law, business owners who desired limited liability chose to operate as either a C corporation, S corporation or a limited partnership. If they chose the C corporation form, they paid two levels of taxes. With an S corporation there are limits on the number of shareholders, only one class of stock can be issued and only certain people or entities can be shareholders. With a limited partnership, there has to be at least one general partner who has unlimited liability and any limited partner who exerts control jeopardizes his or her limited liability protection. The option of choosing an LLC allows business owners the limited liability of a corporation while at the same time only having one level of tax like a partnership. Essentially business owners are able to have the best of both worlds.

Why consider gifts of LLC interest?

It is very likely that most, if not all planned giving professionals, have handled gifts of C corporation stock (i.e. any publicly traded stock). Many have even worked with gifts of S corporation stock, gifts of a partnership interest and/or gifts from a sole proprietor. It is not very likely, however, that many have dealt with gifts of an LLC interest. This is probably due to LLCs being the “new kid on the block” when it comes to types of business organizations. In California, for example, LLC were first allowed as a type of business entity with the passage of the Beverly-Killea Limited Liability Company Act of 1994, a mere 16 years ago.

Because LLCs offer limited liability and only one level of tax, many new business owners choose LLCs as their choice of business entity. Reviewing the number of tax returns filed with the IRS between the years 2004-2009, it is evident that partnership tax returns are on the rise while corporate tax returns have declined. (While partnerships and LLCs do not pay taxes at the entity level, they are still required to file IRS Form 1065 which computes taxable income at the entity level.)

Tax Year ¹	Partnership Returns ²	S Corp Returns	C Corp Returns ³
2004	2,521	3,504	2,541
2005	2,665	3,634	2,494
2006	2,773	3,825	2,454
2007	3,097	4,099	2,508
2008	3,307	4,440	2,538
2009	3,565	4,496	2,476
Change from 2004-2009	1,044	992	<65>

While there is an increase in the number of partnership tax returns filed between the years 2004-2009, the IRS does not differentiate those returns between partnerships, LLPs and LLCs. Thus, it is not possible to conclude the exact growth of LLCs, but it is the authors' opinions that such growth is attributable to an increase in LLC businesses.

As LLC businesses continue to increase and become successful, it is highly likely that non-profits will see a concurrent rise in the number of LLC interests offered as charitable donations. It has been the authors' experience that charitable organizations shy away from gifts in which it has little or no experience. Thus, it is important for non-profits to prepare and have a plan to handle such gifts so when offered an LLC interest, a good opportunity is not lost. Likewise it is just as important for the non-profit to be able to determine when an offered LLC gift needs to be declined so that it does not jeopardize the operations of the non-profit.

What to do when offered an LLC interest.

Given the increase in LLC businesses and the current depressed stock and real estate valuations, donors and non-profits are looking for alternative ways to give that will maximize both tax deductions and benefits to non-profits. LLC interests can be an alternative way of giving that is beneficial to both donors and non-profits. When such an opportunity is presented to the non-profit organization, it is very important to be prepared to properly assess the offered gift and make the appropriate acceptance decision.

¹ <http://www.irs.gov/taxstats/article/0,,id=171961,00.html>

² IRS Form 1065 includes both partnership and LLC returns

³ Includes Form 1066 (real estate mortgage investment conduit income tax return) and the Form 1120 series as follows: 1120 (corporation income tax return); 1120-A (corporation income tax return short form); 1120-C (cooperative association income tax return); 1120-F (foreign corporation income tax return, except foreign life insurance company, foreign property and casualty insurance company, or foreign sales corporation); 1120-FSC (foreign sales corporation income tax return); 1120-H (homeowner association income tax return); 1120-L (life insurance company income tax return); 1120-ND (income tax return for nuclear decommissioning funds); 1120-PC (property and casualty insurance company income tax return); 1120-POL (income tax return for certain political associations); 1120-REIT (real estate investment trust income tax return); 1120-RIC (regulated investment company income tax return); and 1120-SF (income tax return for settlement funds). Form 1120-X (amended corporation income tax return) is included with Supplemental documents in this table. Excludes Form 990-T (tax-exempt organization "unrelated business income" tax return), which is included under Tax-exempt organizations in this table, although the tax reported on these returns is combined with Business income taxes in other tables.

When offered an LLC interest gift the first item to review is the non-profit's gift acceptance policies. The gift acceptance policies should state whether such gifts are acceptable to the organization and if so, the process by which approval should be obtained. If the non-profit does not have gift acceptance policies or the policies do not address LLC interest gifts, sample gift acceptance policies can be found through an internet search or by asking colleagues at a similar non-profit organization.⁴ It is important to have the policies in place prior to receiving an offered gift.

Once it is determined that the non-profit organization is willing to accept the gift, if appropriate, the next steps are to ask preliminary questions from the potential donor and gather information.

Questions the gift planner should ask:

1. Why are you making the gift?

One of the key questions to ask the donor is, "Why do you wish to make a gift?" This question may not be as important if the donor has a longstanding relationship with the non-profit or if the donor is a board member. But, if this is a donor who is new to the organization, motive is important. Many seasoned gift planners are well aware of "donors" who wish to dump their property at a non-profit. Finding out why a donor is making a gift is very important particularly because of the complex due diligence issues surrounding a gift of an LLC interest.

2. What is the LLC business?

Another key question to ask is, "What type of business does the LLC operate?" This question is important for several reasons. Primarily because the non-profit needs to know what type of income the LLC generates. For example, if the LLC only owns rental property, the income will usually be passive income and not taxable to the non-profit. On the other hand, if the LLC operates the local 7-Eleven, that is an active business and all the net income will be active trade or business income to the non-profit. If an LLC generates active trade or business income that income is considered unrelated business taxable income ("UBTI"). UBTI is not necessarily bad for a non-profit. The non-profit will pay taxes on such income, but the net income will be income the non-profit would not otherwise have⁵. It is also important to be aware of UBTI because if a non-profit has too much UBTI when compared to fundraising income it is possible for the non-profit to lose its tax-exempt status. That would be an extreme circumstance, but one the non-profit should be aware when assessing the viability of an LLC gift.

Not only is it important for the non-profit to be aware of the type of business activity for the reasons stated above, but it is also important to ensure such activity does not conflict with the non-profit's purpose. For example, if the LLC is in the business of making fur coats, a gift of an LLC interest to an animal rights organization would probably not be appropriate. While a conflict is unlikely, it is helpful to know upfront if there will be any issues between the business conducted within the LLC and the non-profit organization.

⁴One such website is Kathryn Miree's.

<http://www.kathrynmireeandassociates.com/PDF/Sample%20Gift%20Acceptance%20Policies%20May%202008.pdf>

⁵ I.R.C. §511 et seq.

3. Are there any other members and if so, who are they?

During the information gathering phase, the gift planner should find out if the LLC has any other members besides the donor. If the answer to that question is affirmative, the gift planner should determine who the other members are because when a non-profit accepts an LLC interest, that non-profit is in essence entering into the business with the other members. It is imperative for the non-profit to be aware of the other players. While there might not be conflict between the non-profit and the LLC, there may be conflict between the non-profit and one or more of its members. Perhaps one member of the LLC does not have a good reputation in the community, the non-profit must assess whether it wants to be connected to that particular member. Also, if the other members are not particularly friendly to the non-profit it could make the business relationship difficult and may not be worth the value of the gift.

If the donor is the sole LLC member, that LLC will be a single member LLC, in which case the non-profit will likely explore a gift of LLC assets rather than a gift of the LLC interest. Adding the non-profit as an LLC member will no longer allow the LLC to be a single member LLC.

It is also important to find out the LLC's net profits or losses. If the LLC has continued losses, this is not likely a good asset for the non-profit. Very likely, however, the LLC will be solid financially which is why the donor is using it to make a charitable gift. But, it is good to have this information upfront.

4. Is there any debt?

This is a critical question because the non-profit should know the liabilities of the LLC before it accepts the membership interest. The non-profit also needs to review the Operating Agreement to determine if it will be liable for any of the debt or whether there will be a future capital call. The amount of debt, if any, may be an indicator of how successful the LLC will be in the future.

5. How do we get out?

Exit strategy is very important when a non-profit is considering an LLC interest gift. At this point in the process the non-profit should consider if it is going to hold the LLC interest as an investment or if it will sell the interest as soon as possible. Usually these types of interests do not have a resale market. Therefore, the likely party to purchase is the donor. Selling to the donor or one of the other LLC members is permissible so long as the sale is at fair market value and the arrangement is not prearranged.

6. Is this an outright gift or does the donor desire an income stream in return?

This is one of the most important questions. As the gift planning officer, you may be handling this gift request because all odd-ball gifts seem to somehow land in the office of planned giving. You may also be handling this gift however, because the donor wishes to fund a planned gift with the LLC interest. If the donor is going to receive an income stream in exchange for the LLC interest, another layer of complexity is added and additional analysis is required.

- Outright gift – When receiving an LLC interest, an outright gift is generally best for the non-profit. Especially if the non-profit does not know how successful the interest will be. With an outright gift, there is not a lot of downside. If the interest loses all its value, the non-profit does not lose much, if anything.

- Charitable Remainder Trust – It is highly unlikely that a charitable remainder annuity trust (“CRAT”) would be used unless an income stream from the LLC interest can be guaranteed. Funding a CRAT with any unmarketable asset is highly risky because the trust must make at least annual payments even if there are no liquid assets in the trust and the payout is based on the appraised value as determined at trust funding. Determining the fair market value of an illiquid asset is not easy and could be an issue if ultimately not correct. A charitable remainder unitrust (“CRUT”) is the more likely option if a charitable remainder trust is desired. Selecting a net income with make-up, net income or a flip trust is recommended. With either of these types of CRUTs only the LLC income will be distributed and if there is no income, no distribution has to be made.

If the LLC interest funds a CRUT, it is very important to ensure that all income from the LLC is passive income. If there is any active income, the active income will be subject to a 100% tax. Another caution is to ensure there is no debt. Debt can also cause unrelated business income tax to be imposed on the CRUT.

- Charitable Gift Annuity – It would be very rare for a charity to issue a charitable gift annuity (“CGA”) in exchange for a gift of an LLC interest unless the non-profit had a buyer waiting in the wings (without a prearranged sale) and it is certain the sale would be completed. The risk with a CGA is the payments are for the life of the donor and the amount of the CGA payments are based on the value of the LLC interest at the time the CGA is created. If the LLC interest is difficult to sell, sells for considerably less than the value upon which the CGA contract was written, or in a worst case scenario, loses all its value, the non-profit could have a big loss. The fixed payments and security that the CGA provides for the donor creates a lot of risk for the charity when an LLC interest is used as the funding asset.

What information should be collected?

If after asking the appropriate questions and determining whether the LLC interest will be gifted outright or in exchange for a life-income gift, the next step is to collect information on the LLC. This is the due-diligence part of the gift. Below is the information that should be collected. It is helpful to request the information as soon as possible because some donors may take a while to find the information or get it to the gift planner.

1. LLC operating agreement

The operating agreement is essentially the rules for operation of the LLC. The agreement would indicate whether it is permissible for the non-profit to be added as a member, the procedure by which a new member is added, whether there can be capital calls, and if the non-profit may need to participate in a capital call, who manages the LLC, whether the non-profit will have any decision making ability as an LLC member and the how the non-profit can exit the LLC if it chooses to exit. It is helpful to have the operating agreement as early in the review process as possible so it can be thoroughly reviewed.

2. Copies of financial information

The gift planner should request copies of the last three years of partnership informational returns and of the donor's K-1's. This information will help to assess how well the LLC is performing, the income stream, if any, the non-profit can expect to receive and the general health of the LLC.

3. List of LLC assets and debt

It is helpful to know the LLC's underlying assets. This information will also help answer some of the questions the non-profit should ask, such as what type of income the LLC produces. Knowing any outstanding debts is also important especially if the non-profit may be liable for any debt.

Assessing the information - issues of concern.

Once all the information has been gathered, the non-profit needs to examine the information. If the gift planner does not have the expertise to adequately assess the information then perhaps outside counsel should be retained. This of course will incur an added expense for the non-profit, but it may be money well spent.

There are several issues that the person or team reviewing the documents should be looking for. Some of these items have been previously discussed, but are mentioned again because of their importance.

1. Unrelated business income

Unrelated business income is taxable income to the non-profit at the corporate income tax rate and is subject to 100% tax within a charitable remainder trust.

2. Capital calls

The non-profit should know whether it will be required to add any capital to the LLC and if so, when capital calls might be made and how quickly it may have to come up with the funds.

3. Other members

It is important for the LLC to know what other people, besides the donor, it is getting into business with.

4. Conflict with the non-profit's purpose

Is there anything about the activities of the LLC, its members or anything else that may conflict with the non-profit's charitable purpose? If so, it is best to disclose any conflict as soon as possible.

5. Exit plan

The non-profit should always have a clearly defined exit plan before it enters into an LLC. Preferably, the exit plan should not result in a significant loss of the value of the non-profit's interest.

6. Appraisal and minority discount

An appraisal of the gift as such should be discussed with the donor early in the process. Because LLC interests are typically closely-held, an appraisal can be expensive. It is not uncommon for such an appraisal to cost anywhere from \$10,000 to \$25,000. Further, the donor is very likely to give a minority interest to the non-profit. If this is the case, a minority discount will be required. This will increase the

cost of the appraisal. Deciding who will bear the cost of the appraisal should also be discussed. It is important that the expectations of both the donor and the non-profit be discussed early in the process.

Making the recommendation.

Once questions have been asked, information has been gathered and reviewed, it is time to make a recommendation to the non-profit decision makers as to whether or not the LLC interest should be accepted.

In making the recommendation, it is important to highlight to the gift acceptance committee information, such as what is the LLC's primary business, who the members are, what is the projected income or value of the LLC, what is the likely exit strategy, how soon may the non-profit exit or the length of time it plans to hold the interest, whether or not the non-profit need to provide any capital now or in the future, and if there is going to be an income interest to the donor. The previous list is not inclusive. The gift planner should also include any items that present a large risk to the non-profit and if appropriate the worst case scenario if the gift is accepted and the health of the LLC deter rates.

Case Study

Donor Profile

Mrs. R is 78 years old and the matriarch of a very large family in Southern California which acquired land through land grants over 100 years ago. Over the years, the family has acquired more land and operated ranches, acquired orange groves, explored for oil, and built and operated golf courses. As the family grew, it was decided to place the family businesses into a LLC to centralize management, obtain limited liability and maintain the family businesses without needing to split up the various business enterprises. The LLC makes some distributions to its members, but generally retains most of the funds for more real estate acquisitions and therefore Mrs. R's interest in the LLC is not producing much income. Mrs. R is now ready to exit the family business and would like to start to realize a greater return on the value of her interest in the LLC. Mrs. R is very involved with her favorite charity, "Favorite Charity." She has approached her friend, Sally Savvy, (the major gift and planned giving officer at Favorite Charity) because she received a newsletter from Favorite Charity about some estate and charitable planning ideas and wanted to find out more about them.

Goals

1. Mrs. R wants to exit without paying substantial capital gains tax.
2. She also doesn't want to burden the LLC without a buyout which will drain capital and cause the company financial stress.
3. Mrs. R has agreed to take a leadership role in Favorite Charity's upcoming campaign and would also like to make a substantial gift to Favorite Charity.
4. Finally, Mrs. R needs more income, however she is not a big risk taker.

Issues

1. The income of the LLC is trade or business income and therefore unrelated business taxable income.

2. The LLC is a private family business and does not make regular distributions to its members except to distribute an amount sufficient to pay the income tax liability on each member's allocable share of income plus a small amount in excess of that amount.
3. The LLC is owned by Mrs. R (30%) and by a holding company which is further owned by multiple trusts representing over 100 beneficiaries. The other LLC members are not interested in having Favorite Charity as a partner.
4. The LLC Operating Agreement has buy-sell provisions and none of the provisions allow transfers to charitable organizations.

What Would You Do?

ANSWER TO CASE STUDY ON THE FOLLOWING PAGE

Case study solution

After considerable time and analysis, it was determined that the vehicle which most closely would meet the goals and objectives of Mrs. R was a Charitable Gift Annuity. Mrs. R's desire for a secure fixed income was the primary motivator for using this type of vehicle.

However, there were a lot of "hoops" to go through in order to make this gift a good gift for Mrs. R, Favorite Charity and the LLC.

1. The Operating Agreement for the LLC had buy-sell provisions that did not allow the transfer of any LLC interest to a charitable entity.
2. Additionally, it was important to have an exit strategy in place for Favorite Charity because it did not want to have an illiquid asset that would not assist Favorite Charity in its charitable mission and such exit strategy also needed to be structured in such a way so that the capital needs of the LLC would not be compromised.
3. Most importantly, Favorite Charity did not want to hold the LLC interest long-term because the income generated by the LLC interest was unrelated business taxable income and thus, it was important to Favorite Charity to sell its interest as soon as possible to avoid such taxable income.

To overcome the foregoing obstacles, the LLC amended its operating agreement to allow transfers to charitable entities. Additionally, the agreement provided that any charitable entity assignee would have the right to "put" its interest back to the LLC which must purchase the interest from the charitable entity on a 5-year note with 10% down and the remaining balance payable over 5 years with commercially reasonable interest. By amending the operating agreement in this fashion, Favorite Charity could have an exit strategy to sell its interest back to the LLC and thereby convert the interest to cash to use for its charitable purposes and by doing so would also stop the flow of unrelated business taxable income to Favorite Charity. The members of the LLC were happy because they had a strategy in place that would allow them to buy out Favorite Charity's interest if Favorite Charity "put" its interest back to the LLC. The buy-out would be based on an installment sale so that its capital position would not be compromised and it would not be in business with Favorite Charity. Finally, Mrs. R was happy because she was able to obtain a fixed, predictable income stream from Favorite Charity in the form of an annuity and at the same time participate in Favorite Charity's capital campaign.