Bashing UBIT to Bits
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Key Learning Objective: Some ways to navigate through the Unrelated Business Taxable Income Rules to: (1) Avoid the Tax, (2) Eliminate the Tax, or (3) Cut the Tax by Half.

Session Description: For years, both the capital gains tax and the estate tax have been referred to as the "Voluntary Taxes." Donors are counseled how to avoid or reduce either of these taxes, by making charitable gifts or by creating planned gift vehicles.

This presentation will cover ways we can make taxes on UBI "voluntary" too. Specifically, the ways to avoid, eliminate, or cut by half the UBTI tax.

Part 1 – *Avoiding* The UBTI

Example – Using A Unitrust For UBTI Planning

Charitable remainder trusts (CRT) are governed by the private foundation rules that tax unrelated business taxable income (UBTI), at a 100% tax rate, on only the UBTI income. So, it is unwise for a CRT to carry on its own unrelated trade or business, or accidently invest in a for-profit business, or one which uses debt-financing to acquire its assets (which is not unusual for a business to do).

However, CRTs can own C corporation stock and not pay taxes when the CRT sells stock or receives corporate dividends.

In Private Letter Ruling 200252096, IRS allowed a Charitable Remainder Unitrust (CRUT) to invest indirectly in a limited liability company (LLC), which uses debt-financing to acquire their assets. The IRS's position seems to be that so long as the CRUT is not investing *directly* in the debt-financing business, but instead is investing in another company, which in turn invests in the debt-financing business, and so long as there are solid business reasons for this arrangement, the debt-financing will not trigger UBTI. Interestingly, the IRS also has not challenged these indirect investment arrangements under the step transaction doctrine either.

A. CRUT Trustee Creates and Funds a for-profit C corporation

In PLR 200252096, IRS approved a CRUT that transferred funds from the CRUT to create a wholly owned for-profit C corporation. Assets of the holding corporation would be separate from the CRUT's assets. The C corporation would use the funds it received from the CRUT to purchase an interest in a limited liability company (LLC), that was in the equipment leasing business. The LLC expected to use debt financing to partially fund the acquisition of equipment.

The CRUT Trustee noted that there were good business reasons for establishing the C corporation to make the LLC investment. The LLC operating agreement restricted the sale or transfer of fund shares. If the CRUT owned the LLC shares outright, it might not be able to sell the shares when it wanted to. By having the CRUT invest in the LLC through the C corporation, the CRUT can sell the LLC investment by selling some or all of the C corporation's stock, without needing the LLC's approval.

The C corporation also provides the CRUT with liability protection. The LLC will lease aircraft and marine vessels in both the U.S. and foreign countries, creating potential exposure to tort liability claims. Because the C corporation will be a member in the LLC, the CRUT's other assets will be protected from tort claims. The C corporation may make additional investments, funded through retained earnings or additional capital contributions. The C corporation's management of the investments relieves the

CRUT's Trustee of this responsibility and insulates the CRUT from possible unrelated business activities that could expose the CRUT assets to liability or generate UBTI.

The IRS ruled that the shares of the C corporation stock owned by the CRUT would not be considered debt-financed property, that would create debt-financed (taxable) income upon a sale. They will instead be investment property. Any gain on the sale of the shares will be excluded from UBTI under IRC §512(b)(5). The IRS also ruled that the corporation's allocable share under IRC §704, of income and gains, or any distributions of cash or property from the LLC to the C corporation, will not be UBTI to the CRUT.

B. Avoiding *and Reducing* the UBTI – Example 1

CRUT Trustee May Create and Fund a for-profit Foreign Corporation

One drawback for the CRUT Trustee in using a C corporation for UBTI planning is that the C corporation itself is subject to tax on its business related profits. This means there are two levels of tax: the corporate level and the CRUT income beneficiary level, when the CRUT pays out the Tier 1 income.

The CRUT Trustee could instead create and fund a for-profit Foreign Corporation (FC) in a jurisdiction where the FC is not taxed at the corporate level. Instead, the FC shareholders are taxed on their FC dividend income. The CRUT however pays no tax on the dividend income it receives. This means there is only one level of tax, at the CRUT income beneficiary level when the

CRUT pays out the Tier 1 income. (See these favorable PLRs involving the use of FCs: PLRs 200315028, 200315032, 200315034, and 200315035; and, PLRs 2002516016 -- 018.)

C. Avoiding *and Reducing* the UBTI – Example 2

A Charitable Organization Pooled Income Fund Trustee May Invest Directly Or Indirectly (through a wholly-owned LLC) In A UBTI Generating For-Profit Business

The Pooled Income Fund (PIF) is not taxed on the UBTI it receives. Instead, it pays 100% of this income to the PIF income beneficiaries, who represent a wide range of tax brackets and who live in States that have an income tax and States that do not.

Unlike a CRT, the PIF does not have a minimum/maximum payout rate, or a 10% remainder interest requirement. And, a “young” PIF offers a dramatically larger income tax charitable deduction.

Compared to the CRUT a PIF may allow a less expensive and more simplified UBTI planning approach, eliminating the need for the CRUT Trustee to create and administer a CRUT and a C corporation or Foreign Corporation.

Part 2 – *Eliminating* The UBTI

Let’s imagine that a new charitable organization decides to organize itself as a non-profit charitable **trust** and have its Trustee organize itself as a non-profit **corporation** and specifically, both the Charitable Trust and Trustee are *Type 1*

Supporting Organizations. Without going into the details, this allows the maximum flexibility when receiving different types of gifts or gift values.

Once these charities are set up, the Charitable Trust then creates a charity-owned single member LLC for a donor who owns a real estate investment company. The donor is appointed as the Manager of the LLC. And let's say the name of the LLC is: "No UBIT For You! Foundation" and it operates somewhat like a DAF and is funded 100% with cash. *(Refer to IRS Notice 2012-52 and that SMLLCs are disregarded entities.)*

What the donor wants to do is either donate a fixer-upper to the No UBIT For You! Foundation, fix it up and then sell it, or, buy a fixer-upper, fix it up and then donate the now higher value property to the No UBIT For You! Foundation.

If the donor did this just one time, it would be unlikely that anyone would call this an active business that was regularly carried on. But noooo! The donor wants to do this 50 qutrillion times. And he doesn't want to pay any UBTI.

You've met this *reasonable* donor. You know this *reasonable* donor. Maybe you are this *reasonable* donor. And there are at least a couple of ways that you can ask the charitable tax experts a crucial question at this point. You can ask the lawyer: "***Can*** this be done?" Or, you can ask, "***How can*** this be done?" The second question can have strange powers over the legal expert so that they become a "can-do" genius!

So, I went with the “How can” approach and here is what happened.

Step 1

The donor’s charity, No UBIT For You! Foundation, made a charitable grant of $99,000 to the Charitable Trust Organization and a charitable grant of $1,000 to the Charitable Trustee Organization.

Step 2

Both the Charitable Trust Organization and the Charitable Trustee Organization created a new LLC, *together*, called the Howcan Property Holdings 1, LLC. This means this LLC had 2 tax-exempt charitable organization owners: the Charitable Trust Organization was a 99% owner and the Charitable Trustee Organization was a 1% owner. So this LLC was not a single member LLC; it was not a disregarded entity.

The donor was appointed the Manager of the Howcan Property Holdings 1, LLC.

Step 3

The Charitable Trust Organization invested its $99,000 into Howcan Property Holdings 1, LLC and took back a 99% ownership and the Charitable Trustee Organization did the same with its $1,000, taking back a 1% ownership.

Step 4

The Howcan Property Holdings 1, LLC Manager, used the $100,000 cash to buy the fixer upper, fix it up and sell it for a profit. Then, the Howcan Property Holdings 1, LLC transferred the profits to the No UBIT For You! Foundation. These profits can be used by the No UBIT For You! Foundation to make charitable grants to various charities.

Step 5

The Charitable Trust Organization and the Charitable Trustee Organization dissolve the Howcan Property Holdings 1, LLC.

Step 6

When the donor finds a new fixer upper property, Steps 1 through 5 are repeated with a new entity called the Howcan Property Holdings 2, LLC. In this manner, no single Howcan Property Holdings LLC ever regularly carries on an active business. The profits from the property sale should be treated as tax-exempt passive income from a one-time event.

Part 3 – *Cutting* The UBIT In Half

It has been reported that the most valuable gifts given to charity every year are stocks in closely held businesses, followed by real estate.

Example – S Corporation Stock Gift and UBTI Planning

Since 1998, S corporation shareholders have been able to give S stock to charities.

When charities are organized as non-profit **corporations** (like most are) and they receive S stock dividends, they can pay a Federal tax of up to 38%, plus a Federal net investment income tax of 3.8%, plus any applicable State income tax. These charities also pay all these taxes on the capital gains when they eventually sell the S stock. This is because there is no lower Federal capital gains tax rate available to **corporate** taxpayers.

In light of this and to encourage tax-wise S stock gifts, a charity that is already organized as a corporation might consider creating a Type 1 Supporting Organization in the form of a charitable **trust**. You do this so that the ordinary income tax liability incurred on receiving S stock dividends, or the capital gains tax liability from an eventual S stock sale, would be no greater than the donor's tax liability would otherwise be.

Non-Profit Illinois Corporation -- Example

A donor donates $10 million in zero basis S stock to a Illinois charity organized as a corporation. The S stock earns $1 million in dividends a year.

The charity's combined Federal tax rate will be 37.8% and the charity's Illinois tax rate will be 5.25%. The combined Federal and State tax rates total 43%.

So, after paying $430,000 in taxes, the charity has $570,000 leftover for its charitable purposes.

When the charity eventually sells the $10 million zero basis S stock, the charity will pay $4,300,000 in taxes and have $5,700,000 leftover for its charitable purposes.

The Non-Profit Illinois Corporation Creates A Type 1 Supporting Organization, Organized As A Delaware Charitable Trust

Example

A donor donates $10 million in zero basis S stock to the Illinois charity's supporting foundation trust in Delaware. The S stock earns $1 million in dividends a year.

Without additional planning steps, the charity's Federal tax rate on this trust income will be 39.6%, which is also the total tax rate; there are no Delaware taxes. Note: Although the Federal trust income tax rate is higher than the corporate income tax rate, there is no 3.8% net investment income tax levied on charitable **trust** income.

So, if we did nothing else, after paying $396,000 in taxes, the charity would have $604,000 leftover for its charitable purposes. This is $34,000 more than what is available for charitable purposes from the non-profit Illinois corporation.

However, the Supporting Organization further plans to donate 50% of the S stock dividend income to the Illinois Charity and receive a $500,000 charitable deduction. Now the Supporting Organization only reports $500,000 of taxable trust income subject to the 39.6% Federal tax. The tax is $198,000, which represents an effective tax rate of 19.8% on the entire $1 million of S stock dividend income.

Because of this additional planning step, the Supporting Organization will have $802,000 leftover for its charitable purposes. This is $232,000 more than what is available for charitable purposes from the non-profit Illinois corporation.

When the Supporting Organization eventually sells the $10 million zero basis S stock, the Supporting Organization will again donate 50% of the S stock gain to the Illinois Charity and receive a $5,000,000 charitable deduction. The Supporting Organization will pay a Federal capital gains trust tax rate of 20% on $5,000,000. The tax is $1,000,000, which represents an effective tax rate of 10% on the entire $10 million of S stock capital gain income.

Again, because of this additional planning step, the Supporting Organization will have $9,000,000 leftover for its charitable purposes. This is $3,300,000 more than what is available for charitable purposes from the non-profit Illinois corporation.

Summary

Thank you for taking another look at the UBIT with me. I hope that with the help of this presentation you will be able to find ways to make taxes on UBI "voluntary" too. New ways to avoid, eliminate, or cut by half the UBTI tax, for the benefit of your donors and your organization.