THE CHARITABLE PARTNERSHIP: A DREAM COME TRUE OR A NIGHTMARE COME TO LIFE?

A. Purpose and Effect.

The purpose of a charitable partnership is to (1) enable a donor to make a larger charitable gift than the donor would feel comfortable making otherwise; (2) enable a donor to make a charitable gift when the donor is making substantial gifts to the donor's descendants; and (3) enable the donor to sell appreciated assets without incurring gain. In the discussion below a transaction with the donor's children is generally assumed. However, the transaction may also be undertaken with grandchildren or other descendants, or with trusts for the benefit of descendants.

B. Mechanics of the Basic Transaction.

The donor creates a limited partnership. The other initial partner may be the donor's spouse or children. Generally forming a limited partnership between a donor and spouse is better than involving children because it reduces the opportunity for the IRS to claim that the donor made a gift upon the formation of the partnership. The partnership may have 10,000 units of which 100 would be general partnership units and 9900 would be limited partnership units. Thus, 99% of the "equity" in the partnership is represented by the limited partnership units while 1% of the partnership controls it.

The partnership would be funded with whatever assets the donor desires. Ideally appreciated assets would be used and care must be taken to avoid the investment company rules (as with all family partnerships). The effects on valuation of funding options should be considered as well. For example, if land is used, more different parcels usually create lower values, e.g. a partnership that contains some undeveloped land and rental properties of various types may be discounted more than a partnership that owns only one kind of real estate.

The donor would contribute the 9900 limited partnership units to a charity. A community foundation is often a good choice because through the foundation the donor is able to benefit multiple charitable beneficiaries. Private foundations are not a good choice because of the self-dealing limitations nor are public charities that are controlled or substantially influenced by the donor.

Section 170 allows the donor to receive and income tax deduction for the contribution of limited partnership units so long as the contribution is not viewed as being of a partial interest. That is, in order for an income tax deduction to be available the partnership must be respected so that the charity is viewed as receiving partnership units rather than a partial interest in the assets of the partnership. For that reason, the charity should receive the full benefits of the units it receives including income distributions and the partnership formalities should be followed completely. In general, the same considerations as a donor would follow to minimize or avoid the application of section 2036(a)(1) in the family limited partnership context are applicable here. The amount of the donor's income tax deduction depends on the fair market value of the units which must be determined by appraisal (Treas. Reg. §1.170A-13).

Most charities do not desire to retain limited partnership interests and thus will want to sell the units. Experience suggests that the most likely purchasers will be one or more members of the donor's family. That may be the children, grandchildren, or trusts for their benefit. The charity should be willing to sell the units for their fair market value which is appraised value. The net effect is that the charity receives appraised value and the children, or other purchasers of the units, receive the value of the partnership above the appraised value.

C. Economics of the Basic Transaction.

[1] <u>With Children.</u>

Is the transaction beneficial to the family and to the charity? Stated differently, is it a good deal? To illustrate, let us begin with a donor with $1,000,000 in cash. The donor, who has used her gift tax exemption, intends to give $700,000 of that to charity and $300,000 to her children. Of the $300,000 for the donor's children, gift tax of about $86,000 will be owed netting to the children about $214,000.

The $700,000 given to charity will remove $700,000 from the donor's estate but will save the donor about $280,000 in income tax (assuming a combined 40% federal and state rate). If the donor took that $280,000 and paid gift tax of $80,000 (assuming a 40% tax rate) the donor's children would receive about $200,000.

So, the donor's children would receive $214,000 plus $200,000 for about $414,000 in this transaction. Charity would have $700,000.

The same transaction with the partnership would have the following results. First, assume that the partnership is funded with $1,000,000 and that the 9900 limited partnership units are valued at $700,000 (approximately a 30% discount). The donor receives a $700,000 income tax deduction upon making the gift to charity which is same as above. If the donor takes the income tax savings and gives them to the children they will net $200,000.

If the children purchase the partnership units from the charity for $700,000 the units would have $990,000 of underlying value. If (when) the donor transfers the 100 general partnership units to the children that value may be unlocked. If it is unlocked, the children will have paid $700,000 for something worth $990,000.

The total benefit to the children is, therefore, $200,000 from the charitable deduction and $290,000 from the unlocking of partnership value for a total of $490,000. The children are ahead by $76,000. Of course, we must still worry about the children's basis (see section [4]).

[2] <u>With Grandchildren or Trusts for Descendants.</u>

The transaction becomes more favorable when assets are moved down more than one generation. To illustrate, a donor with $300,000 of cash will pay $86,000 in gift tax and $61,000 in generation skipping tax (at the 40% rate, tax exclusive because a direct skip), leaving the children with $153,000. Similarly, the donor who makes a charitable gift of $700,000 and receives and income tax deduction of $280,000 may give only $143,000 to the grandchildren after payment of gift and generation skipping tax. Thus the grandchildren would receive $153,000 + $143,000, which is $296,000.

Recall that the yield of the charitable partnership transaction does not vary regardless of the purchaser of the limited units; if grandchildren or a trust for descendants is the purchaser, the benefit remains at $217,500 net of capital gains tax. The value of income tax deduction to the grandchildren remains $143,000. So the grandchildren receive if the partnership is used a total of $360,500. The increase to the grandchildren from using the partnership is $360,500 - $296,000, which is $64,500. If the donor must sell assets to pay gift tax and generation skipping tax the benefits are likewise substantially increased.

[3] <u>Level of the Discount.</u>

The examples above have assumed a discount of 30%. Many appraisers are comfortable with that level, even for marketable securities, especially if the partnership contains shares of only one or two companies. Discounts for real estate often range higher.

[4] <u>Enhancement of the Transaction.</u>

If appreciated assets are used to fund the partnership, the transaction may be enhanced. If the assets are sold while the charity owns the limited units the gain realized by the partnership would be reported to the charity and thus escape income tax. A partner who contributes assets to a partnership must recognize gain from the sale of the assets within two years; however, that rule causes the owner of the limited units to be taxed, in effect, rather than the donor/contributor. Presumably the IRS could attempt to recharacterize the transaction; any such attempt would appear to be minimized, if not eliminated, by having the donor give or sell the general units to the children prior to the time the assets are sold.

In almost every situation the assets inside the partnership should be sold while the charity is the substantial partner. Otherwise, the donee's lack of basis tends to reduce the overall tax benefits.

[5] Role of the Charity.

The charity's role is that of an independent charity looking out for its own best interest. To that end, it will require an appraisal, at a minimum, before selling the limited partnership units. The appraisal may be the same as the donor's appraisal, although the better practice would be to have an independent review. In addition, the charity may have other procedures it follows, such as review of acceptance and disposition of partnership units by special committees; requirements that it be indemnified against liability and unrelated business income tax before it accepts the units; and "shopping" the units to potentially interested purchasers (e.g. "advertising" the availability of units to the financial community through private communications, notification to the charity's board, etc.).

Charities are required to disclose the disposition of contributed nonmarketable assets sold within three years of receipt by filing a Form 8282 (Donee Information Return) within 125 days after the disposition. In many instances charities have as policy the retention of nonmarketable assets during the three year period. If the partnership units are to be retained, then another appraisal will be required at the time of the sale and should be procured by the charity.

An independent charity is best to ensure that the IRS does not conclude that the sale of the units was conducted in other than an arms-length manner. Although private foundations should not be used for this purpose – because of concerns about self-dealing arising not only from the sale of the units but also from the acquisition and retention of the units – supporting organizations may be. Special care should be taken to ensure that all decisions about the retention and sale of the units are made by persons other than the donor or the donor's family.

[6] Poor Children.

A common concern about the charitable partnership is that the children do not have sufficient assets to purchase the limited partnership units. Generally it is a concern raised by the charity. Experience suggests that it is not a concern in most family situations. The reason would appear to be that most persons who are ready to contribute significant amounts to charity have already given significant amounts to their descendants or at least in trust for their descendants. However, if that is not the case, or if the costs of generating the funds is prohibitive – e.g. the basis of the purchaser in the assets to be sold to raise cash to purchase the units is zero or very low – then a variation may be used.

The partnership may sell the assets it owns and generate cash. With that cash it may redeem partnership units from the charity, at the appropriately discounted value, thereby, indirectly, increasing the value of the remaining units. To illustrate, suppose donor creates a partnership with 100 general partnership units and 9900 limited partnership units and gives the 100 general partnership units to a trust for the benefit of the donor's descendants (value is 1% of the amount in the partnership; a $1,000,000 partnership produces a $10,000 gift). The trustee, as general partner, orders all of the assets of the partnership to be sold and then negotiates a redemption of the charity's units at appraised value. If the charity's 9900 limited units are redeemed for $700,000 the partnership has only 100 general partnership units remaining and owns $300,000 in assets. As before, gain will be triggered if the partnership is liquidated. In many instances it may be desirable to retain the form of a general partnership interest in which case a few limited units may be given to the trust or to the donor's descendants.

Transactions structured in this manner have been advocated across the country by a number of different entities and planners. In certain versions the redemption occurs at deeply discounted values, supported, in some instances, by giving the charity the rights to put the units to the partnership for specified amounts. To illustrate, the partnership might provide for a 50 year term during the first year of which the charity would have the right to put the units for 2% of the partnership's book value, during the second year for 4%, and so forth. Planners will need to evaluate such arrangements carefully.

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